The New York Certified Public Accountant

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BOOK REVIEWS

Routine Auditing Procedures for Interdepartmental Auditors, Model City, U. S. A.

By William D. Gasser. Published by Miller, Franklin, McLeod & Company, Rochester, N. Y., 1952. 60 pages.

This monograph deals with the subject of internal auditing for municipalities. It devotes five pages to a discussion of the internal auditor's qualifications and duties, ten to outlines of general audit procedures, and forty-five to specimen departmental audit specifications. These procedures and specifications were developed by independent certified public accountants as a result of an actual study and survey of a city with a population of over 300,000, and are offered as a guide for use in establishing effective financial internal safeguards in other cities.

It would appear that all of the suggested procedures for verification of documents and records in support of receipts and disbursements are intended to be on a post-audit basis. Those procedures which relate to the audit of claim vouchers and, to some extent, those dealing with payrolls should also be a prerequisite to payment. Thus, if the accounts are also audited by independent private accountants and/or state examiners, these auditing processes may have to be carried out as many as four times before the documents are finally laid to rest.

To reduce this unnecessary duplication, perhaps the City Auditor should either (1) eliminate this phase of his audit entirely, (2) reduce it to a test-audit, or (3) arrange with the City Comptroller to eliminate his pre-audit of expenditure documents and to accept one made by a member of the City Auditor's staff.

The specimen departmental audit programs are quite comprehensive, and the work is presumably intended to be performed on a continuing basis at stated intervals. The amount of work involved may be lessened, without material loss of effectiveness, if certain phases were to be reduced to a test-check basis and others performed only for certain periods at designated intervals. Items which may be so treated can be readily determined from a study of the details of the suggested programs.

Professional accountants and government officials who may be concerned with the problem of internal audit and control should find this publication of considerable assistance in devising adequate methods or in strengthening those already in existence.

Ernest W. Carr

New York, N. Y.

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BOOK REVIEWS

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How To Handle Renegotiation

By William J. Casey and C. Richard Gunzer. Business Reports, Inc., New York, N. Y., 1952. Pages: 204; $24.00.

Messrs. Casey and Gunzer have brought considerable light to the definition of "excessive profits" as applied to prime and subcontracts under the current Renegotiation Act. (The Act defines the term "Excessive profits" as "those profits deemed to be excessive"). This new volume presents a comprehensive analysis of renegotiation procedures and offers a company an opportunity to compare its results—before and after renegotiation—with the treatment afforded to others in the same industry. The authors have presented a study which outlines the development of a case for presentation to The Renegotiation Board and they explain how a company may justify a higher than normal profit through the application of the statutory factors. The book includes a survey of over 200 cases which government contractors have filed in the Tax Court.

Included are the following subjects:

I How Renegotiation Works
1. Background of renegotiation
2. What business is subject to renegotiation
3. Segregation of sales
4. Costs on renegotiable sales
5. What is a reasonable profit?
6. How excessive profits are adjusted
7. Procedures in renegotiation

II How to Prepare for Renegotiation
1. Check list of renegotiation steps
2. Original pricing
3. Voluntary refunds
4. Renegotiation liability in financial statements
5. Gathering evidence
6. Preparing standard form of contractor's report
7. Contractor's information and work sheet
8. Organizing for the renegotiation conference

III Renegotiation Results—Aids in Developing Your Argument
1. Developing your argument
2. Arguing your side in a renegotiation case
3. Checklist of arguments in tax court files
4. Renegotiation results
5. Specimen arguments in tax court briefs
6. Industry profit and expense ratios
7. Company profit and turnover figures

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BOOK REVIEWS

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The authors have done considerable research work in analyzing many of the renegotiations on public record; in gathering data pertaining to rates of profit on sales, on net worth, and on capital values in various industries and companies within an industry; and, in suggesting the development of arguments for presentation to The Renegotiation Board.

The book is an excellent guide to the business man submitting his case for justification of profits earned on government business and it should be of great assistance in appealing a decision to the Tax Court. The volume provides answers to many perplexing questions concerning the organization of financial and factual data, including instructions for filing the various forms. As indicated in the preface of the book, the authors have attempted "to furnish practical guidance on preparing for and handling the renegotiation of defense contracts and subcontracts." This goal has been accomplished in a very skillful manner and the volume is highly recommended as being of great assistance to the executive and professional man engaged in presenting a renegotiation case to the government.

This reviewer was very much interested in the last chapter of the book which includes profit and turnover data for several large companies in the industries which have been subject to renegotiation. As he concludes this review, he still wonders what the "fixed asset turnover" implies and how it may be considered as a yardstick for "reasonable" profits. This is still "one" of the many mysteries of renegotiation which we may never know! One thing is certain—that, like taxes,— renegotiation will still be with us while we remain in a mobilized economy.

HORACE J. LANDRY

Syracuse University
Syracuse, N. Y.

Budgeting Expenses in Small Companies

By Arthur W. Nevins. Studies in Business Policy, No. 58 of the National Industrial Conference Board, Inc., 1952. Pages: 44. Distribution is limited to Associates of Board.

This study is divided into four main subsections; (1) What is Budgeted, (2) The Budget Period, (3) How Budgets are Prepared, and (4) How Budgets are Used. The dominant objective of the report is to demonstrate that budget procedures need not necessarily be complex and unwieldy, and that there are many phases of small business management that can profitably employ methods of budgetary control. The operation of a budget department, with its usual complement of statistical and accounting specialists, is

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BUSINESS AND PERSONNEL OPPORTUNITIES

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Announcement of

1953 Prize Essay Contest!

The Board of Directors of the Society has authorized the Committee on Publications to conduct a prize essay contest among seniors and graduate students majoring in accountancy, duly enrolled in the colleges of New York State. The article may cover any topic in the field of accounting and/or auditing.

Prizes in the amount of $100 for the best article and $50 for the second best article are offered. In addition, the two winners and any others submitting papers worthy of honorable mention will receive a one-year subscription to *The New York Certified Public Accountant.*

The General Rules of the Contest are as follows:

All papers shall be original, and the manuscript shall be typed in duplicate on 8½ x 11 stationery on one side, double or triple space typing, and shall not be more than 6,000 words in length. Each contestant shall indicate the exact number of words in his paper at the end thereof.

★

The name of the individual submitting the paper shall not appear thereon, nor should there be any other means of identifying the manuscript, which should be accompanied by a covering letter giving the contestant's name and address. When submitted to the judges, each manuscript will be given a key number for identification.

★

Manuscripts should be forwarded to The Managing Editor of *The New York Certified Public Accountant,* 677 Fifth Avenue, New York 22, N. Y., on or before May 15, 1953. Awards will be announced as soon thereafter as possible.

★

All papers submitted shall become the property of the New York State Society of Certified Public Accountants and shall be available for publication in *The New York Certified Public Accountant.* The decision of the judges shall be final as to what papers, if any, may be entitled to prizes.

BOOK REVIEWS

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frequently associated with the operations of big business exclusively. In appraising the suitability of the budget procedures as developed herein, it is necessary to study them as applied to a "small business" as defined by the author. For this purpose any business is considered as small if it has fewer than 500 employees or gross sales of less than ten million dollars. This definition of a small business may not coincide with the popular use of the term.

The sub-section devoted to "How Budgets are Prepared" does, in fact, outline a very thorough and extensive plan of budgetary control. The author assumes an organization represented by a controller and a manager of "Budgets and Forecasts." Such a degree of departmentalization is hardly consistent with a pattern of avoiding complex arrangements. For instance, the production budget is explained as a "conversion of the sales forecasts" with the employment of standard costs where standardized products are manufactured.

This report is augmented by eleven case studies of firms considered as representative of small business. In the opinion of this reviewer, this report is a valuable survey of budget procedures that are adaptable to large as well as some small businesses.

LAWRENCE W. SHERRITT

Accounting and Its Managerial Use

By William E. Thomas. Bulletin of the Business Management Service of the College of Commerce, University of Illinois, April 1952. Pages: 31.

This booklet is divided into two parts: (1) Nature and Purpose of Accounting and (2) Accounting as an Aid to Managerial Control. The first half is addressed to anyone who may desire a simplified explanation of how the accounting system functions. Most of the language is non-technical and all steps are supported by pictorial sequences. Ample illustrations show the source of information as shown on the fiscal statements.

The second half of the booklet is addressed to the management of a manufacturing business. By a series of diagrams and charts the functional breakdown of the accounting system is cleverly portrayed. Simple illustrations are given for the use of standard costs, actual costs, variances, and analyses.

This little booklet accomplishes its objective exceedingly well, namely, to convey, as simply as possible, the workings of the accounting system and the extent and character of cost accounting data which may be advantageously utilized by management.

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THE NEW YORK
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EMANUEL SAXE, *Managing Editor*

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The 1952 Federal Tax Conference

By BENJAMIN GRUND, C.P.A.

THE Society held this Conference on November 17 and November 18, 1952, under the auspices of the Committee on Federal Taxation. The subjects were selected and presented on the basis of their value to the practicing Certified Public Accountant.

We were not only honored by an excellent paper that was given by District Commissioner C. R. Krigbaum, but also heard twenty-one additional papers which covered the important problems confronting the accountant in his tax practice. In this issue we are presenting the paper of the District Commissioner and as many of the remaining papers of immediate interest as space will permit. Additional papers will be published early in 1953.

It was again emphasized at the Conference that a non-partisan commission like the Hoover Commission to study the federal tax laws should be created as a permanent and simplified policy of federal taxation. The numerous changes made annually in the Internal Revenue Code during the past dozen years have unduly complicated the entire tax pattern and have left a crying need for a complete overhauling of our federal tax laws, and a reconstruction and recodification along simple lines. This kind of action is needed if we are to remove the necessity for the continuous technical changes year after year, which make it difficult for both taxpayers and tax accounting practitioners to obtain a working acquaintance with the law. Simplification is as important as tax reduction to both the government and taxpayers alike.

BENJAMIN GRUND, C.P.A. and member of the New York Bar, is a member of our Society and of the American Institute of Accountants. He is Chairman of the Society's Committee on Federal Taxation and is currently serving as a member of the Board of Directors. Mr. Grund is a partner of Seidman & Seidman, CPA's.

The accounting profession, as well as a variety of business groups, has long advocated that a non-partisan commission be set up to go to work on the tax laws. The commission should consist of representatives of important economic groups, the legislative and administrative branches of the government, and of accountants and lawyers experienced in the income tax field.

In order to achieve tax simplification it is obvious that the job of recommending a permanent policy should be placed in the hands of people who are not concerned with details of day-to-day legislative problems, and are not under constant pressure to give special relief to one category of taxpayers or another.

The Operation of The New York City District of The Bureau of Internal Revenue Under The Reorganization Plan

By C. R. KRIGBAUM

I DEEM it a great honor to be privileged to address your Society on a subject of mutual interest, namely, the Operation of the New York City District of the Bureau of Internal Revenue, under the Reorganization Plan.

Familiar with the problems of enforcing the tax statute, both by training and experience, you are a particularly appropriate group with more than an adequate background for such subject. As a unit and as individuals, you exercise wide influence and play an important role in establishing better public relations between the Government and the taxpayers you represent. A better public understanding of our activities means a more cooperative and satisfied taxpayer. We have much in common and everything to gain by mutual cooperation and you therefore are entitled to know what is going on affecting your sphere of professional activity.

I feel as one of the family. My office has always received the fullest cooperation from the members of the accounting profession. To say that I shall always appreciate it thoroughly, is an understatement. My experience in New York City has convinced me that despite their enlarged responsibilities resulting from the enactment of one Federal tax statute after another, the accountants have maintained the highest standard of professional conduct.

As you know, ours is a self-assessment income tax system. Under this system, you and the taxpayers play a most important role in successful tax administration. Notwithstanding the numerous and complex laws, you have greatly assisted in effecting taxpayer compliance by the character and quality of returns filed. Whenever called upon for assistance or advice, you have responded wholeheartedly. I have always considered you quasi-public officials, well aware of the significance of your Treasury Enrollment Card, anxious to educate your taxpayers and to settle in a satisfactory manner without protracted litigation and expense, the multitude of questions that constantly arise.

This is our objective also. Without your honest and ethical cooperation, the enforcement of the tax statutes in my judgment would have proven immeasurably less effective. I know that this partnership of mutual interest will continue to be of invaluable service.

At the outset, I should like to comment briefly on certain factors which affected the administration of the tax laws since Pearl Harbor. The problems of peace-time tax enforcement were magnified many times. Experienced employees were lost to the war effort and qualified replacements were not available until later. Inexperienced men required training and seasoning. The housing facilities and operating equipment were inadequate. In the meantime, there was a tremendous increase in tax evasion and black market activities and the innumerable other problems resulting from the extension of the withholding tax feature, estimated tax declarations, war and peace excess profits taxes, Section 722 relief provision, additional excise taxes, and the matching of millions of information returns.

C. R. KRIGBAUM is District Commissioner of Internal Revenue, New York City District.

To illustrate, in 1940 the Bureau handled 20 million returns. This year, nearly 90 million tax returns and over 100 million related information documents are being processed. This is a challenge of no small proportion.

The tax collected in 1940 was about 5 billion dollars. In Fiscal 1952, it was 65 billion, and this, under our self-assessment system. The handling of this dollar and returns volume is a stupendous task in itself, excluding indispensable enforcement activities.

The Bureau's personnel in 1940, numbered about 22,000. Today, it numbers almost 55,000. The increase, however, did not keep abreast of the mounting workload.

Here is a situation resulting from the war which added millions of new taxpayers who had practically no experience in filling out tax returns. In addition, an unprecedented number of returns required audit, including thousands of black market, fraud and racketeer cases, all of which could not be currently disposed of because of the volume and the shortage of technical personnel. The audit of many of these cases had to be deferred until after the war when the personnel was increased from 50,000 as of June 30, 1945, to the all-time peak of nearly 60,000 a year later. So much effort was expended towards collecting the dollars required to meet the war budget that there was little opportunity left for the modernization of the collection machinery. The Bureau was constantly improvising to meet the task of collecting 8 to 13 times the pre-war average. Makeshift improvements sufficient to get by were effected from time to time at different points of the Bureau structure. These at best, were temporary and piece-meal repairs to an old and obsolete machine.

It soon became apparent that a major renovation was overdue. The Joint Committee of Internal Revenue and its advisory group, the Bureau and Treasury officials, the Hoover Commission, and a firm of private engineers hired under Congressional sanction made intensive studies of the tax structure and its administrative facilities. The results of their studies were of paramount importance in the projection of the Reorganization Plan under which our District is now operating.

In general, the Plan provides for the operation of the Bureau along functional lines with management headquarters at Washington. Previously, you identified divisions of the organization with the different types of tax levies, such as income, estate and gift, excise, alcohol and tobacco, social security, etc. Under the Plan, the divisions are identified by the type of work performed—such as collections, audits, appelate, intelligence, administrative. Simplified, it means that each division is responsible for a specific function with respect to all types of tax levies, instead of being responsible for most of the functions in respect of the same type of tax levy. There is only one exception in this new set-up—and that is, the Alcohol and Tobacco Tax Division is still identified by the type of tax. This is due primarily to the fact that the responsibility here involves industry regulation and special enforcement methods.

The Commissioner of Internal Revenue is the top operating and policy official—the only non-civil service person in the Bureau. He has three assistants—one in charge of Operations, one in charge of Technical matters and one in charge of Inspection activities. The Plan provides for the establishment of geographical districts up to 25, headed by a District Commissioner and the setting up of the office of Director of Internal Revenue. The number of Directors has been limited to 70.

Chicago and New York were selected as the first two pilot Districts. On July 1, 1952, the New York City District was officially established and began to function under the Plan. Your interest in the operation of the Plan is natural since approximately six million returns of every character are filed and

processed in this area, which in 1951, accounted for the collection of 8.4 billions of dollars, or 15% of the Internal Revenue collections for the entire United States.

Geographically, this District embraces the territory formerly under the jurisdiction of the Collectors of Internal Revenue of the First, Second and Third Districts. The Office of the Collector and the Office of the Internal Revenue Agent in Charge have been abolished. These two offices have been merged into a new office entitled Director of Internal Revenue. There are three Directors in this District and the boundaries of their jurisdiction correspond to the boundaries of the former Collectors' offices. On January 1, 1953, Rockland, Bronx and Westchester Counties will be added to the present territory and attached to the office of the Director, Upper Manhattan.

The District Commissioner with Headquarters in Manhattan is responsible directly to the Commissioner of Internal Revenue for the general administration, supervision and coordination of all Internal Revenue functions and activities within the New York City District. He has six assistants—each a specialist in one of the following functions — collection, audit, intelligence, appellate, alcohol and tobacco tax and administrative.

There is a District Counsel, who acts as legal advisor to the District Commissioner and his staff.

In addition, there is a Chief Inspector, who is responsible to the Assistant Commissioner (Inspection) Washington, for the direction of the Inspection Service activities in this District.

The Assistant District Commissioner (Collections) is not an operating official. He is a specialist on all functions connected with the Collection procedure and supervises the operations of the Collection Divisions in the three Directors' offices. He acts as an adviser to the District Commissioner.

The Assistant District Commissioner (Audit) advises the District Commissioner on audit programs and supervises and coordinates the audit operations in his District.

The Assistant District Commissioner (Intelligence) acts as Advisor to the District Commissioner and also performs the duties of an operating official. In the latter capacity he is responsible for the investigation of tax fraud, racketeers and the enforcement of the wagering statute. The compact geographical area of the New York City District renders it most convenient to operate with this enforcement unit intact at the District Commissioner's level.

The Assistant District Commissioner (Alcohol and Tobacco Tax) supervises all the alcohol and tobacco tax activities —both permissive and enforcement. Like the Assistant District Commissioner (Intelligence) he is also an operating official, under whom all such activities have been concentrated due to the convenience of operating in a small geographical district.

The Assistant District Commissioner (Appellate) is responsible for the operation of the Appellate Division. He has final authority to settle cases on behalf of the Commissioner. This authority is delegated to him by the Commissioner of Internal Revenue directly. In this respect; his office differs from that of the other Assistant District Commissioners. This independence of the District Commissioner's office in tax settlements frees him from technical direction by any local supervisory official.

The Assistant District Commissioner (Administrative) advises the District Commissioner on problems relating to budget and fiscal matters, personnel, space, training, recruitment of employees, and other functions with respect to administrative records and operations within the three Directors' offices. He supervises the performance of these functions in the District Office.

As already indicated, there are three Directors of Internal Revenue within the New York City District, namely,

Brooklyn, Lower Manhattan and Upper Manhattan.

To assist the Director and to act for him in his absence, an Assistant Director has been designated.

Each Director is responsible for the execution of established policies and procedures covering the assessment and collection of taxes within his district under all the Internal Revenue laws and related statutes.

The Administrative Division handles all the housekeeping functions of the Director's office pertaining to supplies, equipment, files, training, personnel, etc.

The Collection Division embraces the non-enforcement work of the former Collector's office, such as Cashier, Accounting and Returns Processing.

The Audit Division of the Director's office brings together under one management and direction, the former deputy collectors, office auditors, internal revenue agents and excise tax agents. It has taken over substantially the technical work of the former Internal Revenue Agent in Charge as well as the audit and field functions performed by the former Collectors.

One branch of the Audit Division collects delinquent tax accounts and canvasses for delinquent returns. The Office Audit Branch handles the smaller cases and the Field Audit Branch audits all classes of returns, particularly the more complex.

Audits will be made by Internal Revenue Agents under the supervision of a group chief. The groups formerly consisted of 35 or more examining officers. On July 1, 1952, each group was reduced in number to a maximum of 20, including the group chief. The functions of the group chief are both administrative and technical. He also acts as an informal conferee.

Pension Trust rulings will be issued in each Director's office. This function remains decentralized.

The Engineering Section is attached to the office of the Director, Lower Manhattan, and will continue to serve all three Directors' offices and adjacent districts as in the past.

The Miscellaneous Tax Unit, formerly reporting directly and responsible to the Bureau in Washington, has been split up among the three Directors. All work of this type in a Director's office has been brought together and its personnel will be augmented for a more effective coverage of excise tax enforcement.

The Alien Branch, also formerly responsible to Washington officials has been transferred to the office of the Director, Upper Manhattan.

Rulings on past transactions will be made at the Director's level usually at the time the return is audited and reflected in the revenue agents' reports.

Rulings relating to prospective transactions, as well as to policy questions of wide effect, will continue to be issued by the Bureau.

It is apparent that the operation of a Director's office is of much interest to you since that is the office which you and the taxpayer will contact most frequently, for the distribution of tax forms, help in the preparation of returns, filing of returns and claims for refund, payment of taxes, extension of time, purchase of revenue stamps, and answers to any inquiry pertaining to Federal taxes.

However, with respect to audit questions, the principal point of contact will generally be the Head of the Audit Division, in the appropriate Director's office. He has under his immediate jurisdiction, the audit of all tax returns in addition to the handling of delinquent accounts. The audit may be conducted in the field or office, depending upon the character of the issues and the convenience of the taxpayer. There is now—centralized audit control—under a unified management within each Director's office. For example—the smaller individual and miscellaneous tax returns were formerly audited by the Collector of Internal Revenue and

the larger ones by the Internal Revenue Agent in Charge. Each reported separately to different divisions of the Washington office. This situation frequently resulted in conflicting audit jurisdiction.

The audit functions of the two former offices have now been combined under one audit management, the Head of the Audit Division. It will be our aim to reemphasize as often as necessary, the fact that a revenue agent's efficiency is not based upon changes in tax liabilities or the amount of collections but rather upon the correctness of his determinations and the quality of his performance. These factors also call for a judicious exercise of judgment in the treatment to be accorded to minor overlapping items of income or deductions between years.

Although there has been no revision in audit methods, an important change has been adopted in procedure which is designed to speed up determinations with the least cost to the taxpayers and to the Government.

That innovation is the informal conference procedure. It will apply to examinations of income, profits, estate, gift—and with minor exceptions, to excise and employment tax liability. When an examining officer concludes his audit, he will advise the taxpayer of his findings and if the taxpayer is in accord, he will prepare his report and request an agreement. The report will thereafter be reviewed in the usual manner. If approved, it will be typed and a copy transmitted to the taxpayer.

Where the taxpayer does not agree or if he declnes to execute an agreement, the examining officer will inform him of his right to an informal conference and will furnish him with a statement of the proposed adjustments, without tax computations. A copy of this statement will also be furnished to the group chief at the same time. This will enable the group chief to make necessary arrangements for the informal conference if requested, and where advisable—to have available such specialized assistance as may be helpful or necessary in reaching a correct decision.

The examining officer will usually be present at the informal conference. The taxpayer may appear personally or through his duly accredited representatives and may produce witnesses and submit formal or informal documentation.

If the informal conference results in an agreement, the group chief will set forth his findings in a brief memorandum, the conclusions of which will be reflected in the examining officer's report with respect to the issues in controversy. The report will then be reviewed for the completeness of audit and the conformance to the provisions of the Code, regulations, rulings and general Bureau policy. If the reviewer takes exception to the findings of the informal conferee, the issue will be referred to the Head of the Audit Division for advice and guidance.

Where the informal conference results in non-agreement, the group chief will incorporate his findings in a conference memorandum, and the examining officer will prepare his report accordingly. The report will then be reviewed, typed and a copy transmitted to the taxpayer with a thirty (30)-day letter. The taxpayer will thereafter have an opportunity to file a protest under oath, for a hearing on the disputed issues before a conferee in the Appellate Division, which is separate and apart from the Director's office.

It will be observed that the informal conference is held before the revenue agent's report is prepared and before the issuance of the thirty-day letter. This affords the taxpayer the privilege of orally protesting the proposed findings of the examining officer in the first stage of the audit, before an independent official, without the necessity of filing a formal protest and incurring expenses incident thereto. The informal conference method encourages prompt determinations by providing a hearing before the group chief and the examining officer at the earliest possi-

ble time after the issues have been raised.

An informal conference may be denied where possible fraud is involved or where the collection of a proposed deficiency may be in jeopardy.

The Assistant District Commissioner (Appellate) has specific authority to delegate all his settlement powers to certain specified assistants, in order to speed up final closing of a larger volume of cases.

There has been no change in the established procedure in connection with the handling of offers in compromise.

Authority, under Section 3760 of the Internal Revenue Code, to enter into closing agreements covering tax liabilities for past years, has been delegated to the Assistant District Commissioner (Appellate).

The District Counsel is the legal advisor of the District Commissioner. He supervises and coordinates the legal work in the district. The District Counsel's staff includes an Appellate Counsel, Enforcement Counsel, Attorney in Charge—Alcohol and Tobacco Tax and Civil Advisory Counsel, together with a staff of attorneys necessary to carry on the legal work in the District. The District Counsel reports to the Chief Counsel in Washington.

Under the supervision of the District Counsel, the Appellate Counsel furnishes legal advice to the Appellate Division, and tries cases in the Tax Court; the Enforcement Counsel renders legal advice to the Assistant District Commissioner (Intelligence), considers criminal fraud cases and refers them to the Department of Justice for prosecution; the Attorney in Charge—Alcohol and Tobacco Tax, gives legal advice to the Assistant District Commissioner (Alcohol and Tobacco Tax) and attends to legal problems arising out of the activities of that Division, such as issuance, denial, annulment, revocation of permits, searches, seizures and forfeitures; the Civil Advisory Counsel advises personnel in the district respecting legal problems not within the jurisdiction of the other Counsel. He is principally concerned with legal problems arising out of collection procedures, liens, levies, distraint, security for the payment of taxes, claims for taxes in court proceedings, such as bankruptcy and the like.

Prior to the Reorganization, the Collectors of Internal Revenue, the Internal Revenue Agents in Charge, the Technical Staff, Special Agent in Charge, the District Supervisor of Alcohol and Tobacco Tax and Regional Finance reported directly to Washington. Now, these offices have been realigned and there is only one line of authority for supervision and coordination. These offices are under the administrative control of the District Commissioner who reports and is responsible to the Commissioner of Internal Revenue.

There is now closer cooperation and better coordination among the different field offices as well as a better utilization of personnel and equipment. Their activities will be more completely integrated under the Reorganization Plan in due course.

The Civil Service entrance standards for technical personnel have been raised. It is indispensable that the right caliber of men interested in a career service be selected and that once they join the ranks, they must be thoroughly and adequately trained.

An expanded training program has been set up with this long range view as its objective. The Board of Civil Service examiners has been engaged in analyzing technical qualifications of present employees, with a view of utilizing each individual's talents where

most advantageous, on the basis of experience and education.

Training courses will be continued through resident and field class instruction and by correspondence. The subjects taught will be corporation and cost accounting, typing, dictation, English usage, commercial and business law, report writing, excess profits tax, individual and corporate tax law, excise, estate and gift tax, etc. Implementing the foregoing courses, special emphasis will be accorded to public relations and to an improved service to taxpayers.

I am persuaded that the Reorganization Plan represents a major step forward in according the taxpaying public better service at the local level and in effecting closer coordination and supervision of personnel for a more efficient administration of the Internal Revenue laws. Until we succeed in solving the housing problem and the physical merger of appropriate offices, the ultimate benefits of the Reorganization Plan cannot be fully realized.

I am grateful to your Society for its interest in the operation of the Plan in the New York City area. I deeply appreciate your effective and unselfish cooperation in the past. It is gratifying indeed to see organizations of your type working with us—side by side—towards a common goal.

In conclusion, may I say that your observations, comments and criticism of the weak spots, and your suggestions for improvements will be most welcome. Perfection in administration is difficult to achieve under the most favorable circumstances. However, by taking advantage of the opportunities now available for an improved Revenue Service, I trust that we may do a much better job as time moves on.

BUREAU OF INTERNAL REVENUE
LIST OF PERSONNEL
NEW YORK CITY DISTRICT

District Commissioner's Office

District Commissioner	C. R. Krigbaum	90 Church Street New York 7, N. Y.
Assistant District Commissioner—Collection	Edward F. Dingivan	90 Church Street New York 7, N. Y.
Assistant District Commissioner—Audit	Richard D. Donoghue	90 Church Street New York 7, N. Y.
Assistant District Commissioner—Administrative	Norman D. Nowak	90 Church Street New York 7, N. Y.
Assistant District Commissioner—Intelligence	John D. Lathem	253 Broadway New York 7, N. Y.
Assistant District Commissioner—Alcohol and Tobacco Tax	William E. Dunigan	143 Liberty Street New York 6, N. Y.
Assistant District Commissioner—Appellate	Leonard C. Mitchell	350 5th Avenue New York 1, N. Y.
Executive Assistant to Assistant District Commissioner—Audit	Raymond L. Adams	90 Church Street New York 7, N. Y.
Executive Assistant to Assistant District Commissioner—Intelligence	Francis J. Kennedy	253 Broadway New York 7, N. Y.

Director's Office—Brooklyn

Director	Henry L. Hoffman	210 Livingston St. Brooklyn 2, N. Y.
Assistant Director	Raphael Meisels	210 Livingston St. Brooklyn 2, N. Y.
Head, Collections Division	John J. Dunn	210 Livingston St. Brooklyn 2, N. Y.

Head, Audit Division	John A. Duffy	210 Livingston St. Brooklyn 2, N. Y.
Assistant Head, Audit Division	Morris J. Rosenfeld	210 Livingston St. Brooklyn 2, N. Y.
Head, Administrative Division	David M. Ratner	210 Livingston St. Brooklyn 2, N. Y.

Director's Office, Lower Manhattan

Director	Denis J. McMahon	Customhouse Bldg. Bowling Green New York 4, N. Y.
Assistant Director	Jesse O. Schaefer	Customhouse Bldg. Bowling Green New York 4, N. Y.
Head, Collections Division	Raymond F. Ryan, Acting	Customhouse Bldg. Bowling Green New York 4, N. Y.
Head, Audit Division	Harry Herskowitz	90 Church Street New York 7, N. Y.
Assistant Head, Audit Division	Donald C. Diehl	90 Church Street New York 7, N. Y.
Head, Administrative Division	Daniel P. Conway	Customhouse Bldg. Bowling Green New York 4, N. Y.

Director's Office, Upper Manhattan

Director	Harold B. A'Hearn	110 East 45th St. New York 17, N. Y.
Assistant Director	Kenneth W. Moe	110 East 45th St. New York 17, N. Y.
Head, Audit Division	John A. Veit	341 9th Avenue New York 1, N. Y.
Assistant Head, Audit Division	Charles A. Church	341 9th Avenue New York 1, N. Y.
Head, Collection Division	Louis J. Ciccotto	110 East 45th St. New York 17, N. Y.
Head, Administrative Division	David J. Henderson	110 East 45th St. New York 17, N. Y.

District Counsel's Office

District Counsel	Thomas McP. Davis	350 5th Avenue New York 1, N. Y.
Appellate Counsel	Harold D. Thomas	350 5th Avenue New York 1, N. Y.
Enforcement Counsel	Elmer T. Kemper	253 Broadway New York 7, N. Y.
Attorney in Charge, Alcohol and Tobacco Tax Division	John R. Renoe	143 Liberty Street New York 6, N. Y.
Civil Advisory Counsel	Henry C. Clark	292 Madison Avenue New York 17, N. Y.

Inspection Service

Chief Inspector	Frank J. Cavanagh	1472 Broadway New York 36, N. Y.

Problems of Investors in Securities

By Henry Brach, C. P. A.

Change in Treatment of Capital Gains and Losses

The Revenue Act of 1951[1] made substantial changes in the income tax treatment of long-term and short-term capital gains and losses of taxpayers other than corporations. These changes are effective for taxable years beginning on or after October 20, 1951[2]. Hence, 1951 returns of calendar-year basis taxpayers were governed by the old law and the 1952 returns of such taxpayers will be governed by the new law. The change can be stated simply, as follows: Under the old law 50 percent of *all* long-term gains and losses were *non-recognized*[2a] in the computation of net income; under the new law all gains or losses are brought into gross income in full, but a *deduction* from gross income is allowed[3] equal to 50 percent of the *excess* of the net long-term gain over the net short-term loss. (This deduction is a deduction in arriving at adjusted gross income[4] and it has the same effect upon the limitation on the deduction for contributions[5] and medical expenses[6] as though there had been a non-recognition.) Under the old law, the alternative tax of 50 percent was applied to the excess of the recognized 50 percent of the net long-term gain over the net short-term loss. Under the new law, the alternative tax of 25 percent (temporarily 26 percent) is applied to the excess of the full net long-term gain over the net short-term loss.

Henry Brach, C. P. A., is a member of our Society and is Vice-Chairman of the Committee on Federal Taxation. He is also a member of the American Institute of Accountants. He is a partner in the firm of Brach, Gosswein & Lane, CPA's.

The purpose of the change is to make it impossible for a taxpayer to have economic income but no taxable income. Under the old law $1 of net short-term loss offset $2 of long-term gain. Thus, a taxpayer with a net long-term gain of $10,000 and a short-term loss of $5,000 had an economic income of $5,000 but no taxable income. Under the new law $1 of net short-term loss can offset only $1 of long-term gain. Therefore, under the new law, the taxpayer would have $2,500 of taxable income (the $5,000 of net short-term loss would offset $5,000 of net long-term gain leaving an excess of $5,000

[1] Sec. 322(b), Revenue Act of 1951, amending Sec. 117(c)(2) I.R.C.

[2] Sec. 322(e) Revenue Act of 1951.

[2a] "Non-recognized" is not precisely the correct word. Prior to the 1951 change, Sec. 117 (b) I.R.C. provided that only 50 percent of the gain or loss recognized on long-term capital transactions "shall be taken into account in computing net capital gain, net capital loss and net income." However, the use of the word "non-recognized" to mean the portion of the gain or loss not taken into account has been so prevalent in the writing on the subject of capital gains and losses that the writer trusts that he will be forgiven his use of the word in such sense.

[3] Secs. 23(e,e) and 117(b) I.R.C., as added or amended by Secs. 322(a)(1) and 322(a)(2), Revenue Act of 1951.

[4] Sec. 22(n)(7) I.R.C. added by Sec. 322(c)(1) Revenue Act of 1951. Apparently, the purpose of treating the portion of the net long-term gain which is excluded in arriving at net income as a *deduction*, rather than as a *non-recognition* as in the old law, was to avoid the anomalous situation where the reclassification of a capital gain from short-term to long-term might extend the period of limitation on assessment of deficiencies by two years (See Sec. 276(c) I.R.C. and cases thereunder).

[5] Sec. 23(o) I.R.C.

[6] Sec. 23(x).

of long-term gain against which a deduction of \$2,500 would be allowed, leaving a net income of \$2,500).

But, in making the change Congress greatly increased the tax value of long-term capital losses. Under the old law, it took \$2 of net long-term loss to offset \$1 of short-term gain. Under the new law, it takes only \$1 of net long-term loss to offset \$1 of net short-term gain. Thus under the old law, a taxpayer with \$20,000 of net short-term gain and \$20,000 of net long-term loss had \$10,000 of taxable income (the net long-term loss was non-recognized to the extent of 50 percent) even though he had no economic income. Under the new law he will have no taxable income. Under both the old and new laws a capital loss that can not be used in the year in which sustained creates a capital loss carry-over. Such carry-over is a *short-term* loss in the years to which it is carried over even though the loss itself was long-term. There is, however, this difference: Under the old law any long-term loss had been non-recognized to the extent of 50% before it was brought into the computation of the carry-over, whereas, under the new law, the long-term loss is brought into the computation without any non-recognition or reduction.

To illustrate: In 1951, taxpayer had a net long-term loss of \$5,000 and no net short-term gain or loss. Fifty percent of his loss was non-recognized, thus reducing the loss to \$2,500. He was able to deduct \$1,000 from gross income. His capital loss carry-over to 1952 and subsequent years was \$1,500. If the taxpayer had the same \$5,000 net long-term loss in 1952 he would deduct \$1,000 from gross income and have a \$4,000 carry-over to 1953 and subsequent years.

The tax consequences of any particular gain or loss now depend upon the time it is realized in relationship to the time that other gains or losses have been taken or will be taken. Thus, a long-term loss realized in a year in which the taxpayer has other net long-term gains of an equivalent or greater amount will result in a tax saving of not more than 26 percent of the amount of the loss. If taken in a year in which the taxpayer has no other long-term gains or losses but does have a substantial amount of short-term gains the tax saving may be as high as 92% (the highest income tax rate). Conversely, the tax cost of realizing a long-term capital gain, if the other transactions for the year have not produced a net long-term loss, will be 26 percent, or less. But, paradoxical as it may seem, a long-term gain realized in a year in which the taxpayer's other transactions have resulted in a net long-term loss and a net short-term gain will result in as great a tax as though the gain were short-term, which may be at a rate as high as 92%.

The fact that towards the end of 1951 taxpayers were on notice that the rules of the game would change in 1952 gave considerable leeway for effective tax planning. Many a taxpayer will look back with regret at lost opportunities to have placed gains or losses in the best years.

As we come to the end of 1952, taxpayers will again have an opportunity for tax planning by their decisions as to what to do about their unrealized gains and losses. The problem now is somewhat different from what it was in 1951 since we are dealing with two years governed by the same law.

Some of the situations and the reasoning that should be used in reaching the decisions are as follows:

1. Assume that taxpayer has realized only net short-term gains in 1952 and that he has unrealized long-term gains and losses. He should take his long-term losses in 1952 and postpone to 1953 the realizing of the gains. His losses will be offset in full against the short-term gains whereas his gains, if taken in 1953, will, in effect, be non-recognized to the extent of 50 percent.

2. Assume that taxpayer has realized no gains or losses in 1952 and that he has unrealized long-term gains and losses. He has four courses of action: (a) he can take the losses in 1952 and postpone the taking of the gains, (b) he can take the gain and postpone the taking of the losses, (c) he can take both the gains and losses in 1952, or (d) he can postpone the taking of both gains and losses. From the long-range point of view it is advantageous to isolate long-term gains in a single year where they are not offset by losses either long-term or short-term. The least advantageous use of a long-term loss is to offset it against long-term gains. The best use of it is to offset it against short-term gains and the next best use is to create a loss in a year in which there are no other gains. Thus, the best choice is to take the gains in 1952 and postpone the losses (choice (b)) even though it means the incurring of a tax liability for 1952 that could be avoided. The important thing is to preserve the most advantageous use of the unrealized loss.
3. Assume that taxpayer has realized both net short-term gains and net long-term gains in 1952 and that he has unrealized losses which, if taken immediately, will be short-term. He should take the losses while they are short-term. Short-term losses will offset short-term gains. Long-term losses will offset short-term gains only if there are no long-term gains in the taxable year. Therefore, a loss should always be taken while it is a short-term loss, unless it is known that there will be no short-term gains in the taxable year.
4. Assume that taxpayer has a net long-term loss in 1952 to date and that he has unrealized gains which are presently short-term. He should not take the gain until it has become long-term; nor should he take it in 1952. The 1952 loss will create a carry-over to 1953, which will be a short-term loss in that year. If, in 1953, he has short-term gains the carry-over will offset such gains.

Since the decision as to the taking or postponing of gains or losses must be made on the basis of certain assumptions as to what will happen in the future, situations may arise where the very course of action that seemed best at the time it was decided upon will, by reason of subsequent events, turn out to be the worst course of action. To illustrate: Taxpayer has realized a net short-term gain in 1952. He has unrealized long-term losses and gains. He decides to take his long-term losses in 1952 and to postpone to 1953 the taking of his long-term gains and, in accordance with this decision, he takes his losses. Before the end of the year market conditions are such that he decides he must realize his long-term gains—and he does so. Had he known that he was going to realize long-term gains in 1952, he would have postponed to 1953 the taking of his losses (for the reasons heretofore stated). Thus, the original decision to take the losses in 1952 turns out to have been the wrong decision.

Short Sales

The taxpayer should not postpone the taking of his long-term gains even though by taking them in a year in which he has long-term losses which otherwise would be offset against short-term gains, he is going to be taxed on the long-term gains as though they were short-term gains. He may lose more by a decline in the market price than he could save in tax by postponing the taking of the gain to 1953. The use of a short sale is one way of postponing the realization of gain or loss for income tax purposes.

A short sale is a sale of a security which either (a) the taxpayer does not own at the time of the sale, or (b) if he owns the security sold, he intends to complete the short sale by the delivery to the purchaser of stock borrowed for such purpose rather than using his own stock. In the latter situation, the sale is called in the financial community a "short sale against the box". The making of a short sale has no income tax conequences.[7] Gain or loss is realized only when the short sale is *closed* out by the delivery of a security owned by the taxpayer to the person from whom the security was borrowed.[7] The amount of the gain or loss is the difference between the basis of the security used to close the short sale and the proceeds of the sale. Thus, a taxpayer whose tax planning would be disturbed by the realizing of further gains or losses, may protect himself against loss of his economic gain based on present market value or against further economic loss by making a short sale and closing out such sale in his next taxable year.

No taxpayer should make a short sale without a full undertanding of the change in the long-term-short-term consequences of short sales made by the Revenue Act of 1950.[8]

In order that these changes be understood, it is necessary to explain the treatment of short sales under the law as it stood prior to the change. The gain or loss on a short sale was a capital gain or loss[9] and was long or short depending on the length of time the security used to close out the short sale was held[10]. This rule could be availed of to minimize tax liabilities. To illustrate: Taxpayer owned 100 shares of stock purchased at $20. At a time when the stock had been held for not more than 6 months the market price was $50. If he sold at that time he would have a short-term gain of 30 points. What he did was to make a short sale. At a later date, when his long position had been held for more than six months he closed the short sale. He had his choice of two methods: (1) he could deliver his long stock (i.e., his original holding) in which case he had a long-term gain of 30 points, or (2) he could sell his long position in the market and make a new purchase which he would deliver against the short sale realizing a long-term gain on his original position and a short-term gain or loss on the short sale. If at the time he desired to close the short sale the market was higher than the price at which he had made the short sale, he would adopt the second method. If, for example, the market were 80 he would have a long-term gain of 60 points (80-20) and a short-term loss of 30 points (80-50).

The purpose of the new law is twofold: (1) to prevent a taxpayer from having the benefit of a long-term gain unless he had an economic risk for a period of more than than 6 months, and (2) to prevent a taxpayer from realizing a long-term gain and a short-term loss out of what was essentially a single transaction. It should be borne in mind that the change in the treatment of short sales was made at a time when the old law as to treatment of capital gains and losses was in effect and the tax on $2 of long-term gain could be eliminated by $1 of short-term loss. Although the 1951 change eliminated the $2 to $1 ratio, there remain situations where it is to the taxpayer's advantage to have long-term gains and short-term losses (as for example, where he has other short-term gains, in which case the effect of creating long-term gain and a short-term loss is to convert the original

[7] Reg. 111, Sec. 29-117(6).

[8] Sec. 117(1) I.R.C., added by Sec. 211(a) Revenue Act of 1951, applicable to short sales made after September 23, 1950, and to taxable years beginning after that date.

[9] Sec. 117(g)(1) I.R.C.

[10] Reg. 111, Sec. 29-117(6).

short-term gain into long-term gain).

The new law accomplishes this purpose by a device new to taxation but not to diplomacy, namely that of sanctions, i.e., if an undesirable situation exists special rules become effective. These sanctions are three in number. Two of them apply where a taxpayer has made a short sale and, at the time of the short sale, he is long of substantially identical property which he has held for not more than six months or, while the short sale is open, he acquires such substantially identical property. Where such condition exists, (1) any gain on the closing out of the short sale will be short-term, even though the property used to close the short sale was held for more than six months and (2) the holding period of the substantially identical property will begin "on the date of the closing of the short sale or on the date sale, gift, or other disposition of such property, whichever dates occurs first."

To go back to our illustration: If the taxpayer makes the short sale when his long position has been held for not more than six months and he delivers such long securities to close the short sale at a time when his holding period is more than six months, the gain will nevertheless be short-term, (i.e., sanction No. 1 will be applied). If the market price has gone up and he closes his short sale by a covering purchase, he will not be able to get a long-term gain on his long position unless he holds that long position for more than six months from the date of closing of the short sale (i.e., sanction No. 2 will be applied). He does, however, get a short-term loss on the covering of the short sale.

The third sanction is applicable where, at the time of the short sale, the taxpayer has a long position in substantially identical property that he has held for more than six months. In such situation, any loss on the closing of the short sale will be a long-term loss even though the property used to close the short sale has been held for not more than six months. Thus, to go back to our example, if at the time of the short sale at 50 the holding period of the long position was already more than 6 months and the taxpayer closed the short sale by a covering purchase at 800, the loss will be long-term (i.e., sanction No. 3 will be applied.)

Puts

The taxpayer cannot avoid the application of the sanctions by buying a "put" instead of making a short sale. A put is a contract which gives the buyer thereof the right to call upon the other party to the contract (the writer) to purchase from the buyer within a specified period a stated quantity of a specified stock at a stated price. A taxpayer who has a short-term position at a cost below the market can protect himself against a loss of the unrealized profit by buying a put at the market. If the market goes down during the life of the put the buyer exercises the put and sells his stock at the price fixed therein. The drafters of the 1950 Revenue Act were aware of this use of puts and provided that "the acquistion of an option to sell property at a fixed price shall be considered as a short sale, and the exercise or failure to exercise such option shall be considered a closing of such short sale."[11] Thus, if a taxpayer purchases a put instead of making a short sale the three sanctions will be applied.

Calls

A "call" is the opposite of a "put". It is a contract which gives the buyer the right to call upon the other party to sell to the buyer at the buyer's option within the period of the call a stated quantity of a stated security at a stated price. None of the sanctions applicable to short sales are brought into play by the acquisition of a call.

A call, therefore, is a means by which a taxpayer may speculate in securities with a minimum of risk. If

[11] Sec. 117(1)(1) I.R.C.

he buys a call good for a period of more than six months and within that period that market price of the security covered by the call rises, he may either exercise the call and buy the security at the call price or sell the call at a profit. If he exercises the call, the holding period of the stock is measured from the date of the purchase of the security and not from the date of the purchase of the call.[12] But if he sells the call after having held it for more than six months his gain will be long-term.[13] If, on the other hand, the market price is down and he lets the call expire without exercising it, his loss will be short-term.[14]

Substantially Identical Property

One or more of the sanctions described above comes into effect when the taxpayer is simultaneously long and short "substantially identical property." The law does not define the term "substantially identical property." The regulations state that in general the term has the same meaning as the term "substantially identical stock or securities" used in the wash sale section of the tax law.[15] There is a considerable amount of case law and bureau rulings as to the meaning of the latter term.[16] The regulations[15] give the term "substantially identical property" used in the short sale section a broader meaning than the similar term in the wash sale section. Thus, the regulations state that "bonds or preferred stock of a corporation are not ordinarily considered substantially identical to the common stock of the same corporation." However, in certain situations, as, for example, where the preferred stock or bonds are convertible into common stock of the same corporation, the relative values, price changes, and other circumstances may be such as to make such bonds or preferred stock and the common stock substantially identical property. It is the opinion of the writer that in all cases where the taxpayer is long, the bond or preferred stock and is short the common stock into which the bond or preferred stock is currently convertible at the election of the taxpayer the bonds or preferred stock and the common stock are "substantially identical property" even though the fluctuations in their market prices may not parallel one another. But if the situation is reversed and the taxpayer is long the common stock and short the bond or preferred, it is the opinion of the writer that the common stock and the preferred stock or bond are not substantially identical property, for the reason that it is impossible for the taxpayer to convert the security of which he is long into the security of which he is short. The writer sought, unsuccessfully, to have this concept of "convertibility" stated in the regulations.

The regulations[15] also deal with securities of corporations undergoing reorganization and state:

> "Ordinarily stocks or securities of one corporation are not considered substantially identical to stocks or securities of another corporation. In certain situations they may be substantially identical; for example, in the case of a reorganization the facts and circumstances may be such that the stocks and securities of a predecessor and successor corporations are substantially identical property. * * * Similarly, depending on the facts and circumstances, the term [substantially identical property] may apply to the stocks and securities to be received in a corporate reorganization, or recapitalization, traded in on a when issued basis, as compared with the stocks or securities to be exchanged in such reorganization or recapitalization."

In the opinion of the writer, the regulations furnish no guide whatsoever to the taxpayer who wishes to deter-

[12] I.T. 2447, C.B. June 1929, p. 70.

[13] The writer knows of no case which specifically holds that a call is a capital asset. However, it has been held in I.T. 3721, C.B. 1945, p. 164, that a contract to purchase securities "when issued" is a capital asset.

[14] Sec. 117(g)(3) I.R.C.

[15] Reg. 111, Sec. 29.117-10(c).

[16] Sec. 118 I.R.C., Reg. 111, Sec. 29.118-1 and cases and rulings thereunder.

mine whether or not the securities of Corporation A and the securities of the same or of another corporation which he will receive in exchange for the securities of Corporation A if a proposed plan of reorganization of Corporation A is consummated are substantially identical. The writer sought, unsuccessfully, to have the regulations state that the two sets of securities are not substantially identical property until such time that it is *certain* that the holder of one set of securities will be able to exchange them, either currently or at some future date ascertainable with a reasonable degree of accuracy, for the other set of securities.

Other Provisions of the Short Sale Rule

The short sale sanctions cannot be avoided by having one spouse be long and the other spouse short the substantially identical property.[17] However, the sanctions are not applicable if the taxpayer is long and a related taxpayer (other than the taxpayer's spouse) is short, or vice versa.

Where the second sanction (i.e., the change in the holding period of the long position) is applicable and the taxpayer is long several lots of the same security, the sanction applies to the several lots in the order of their acquisition and only to such quantity as does not exceed the quantity sold short.[18] Where the first and third sanctions (i.e., the gain on the closing of the short sale becoming long-term and the loss becoming long-term) are applicable and the taxpayer is short a greater quantity than he is long, the sanctions do not apply to any quantity of the short sales as in excess of the long position.[19]

Traders in commodity futures have received a partial exemption from the short sale sanctions by the inclusion in the law of a statement that "in the case of futures transactions in any commodity on or subject to the rules of a board of trade or commodity exchange, a commodity future requiring delivery in one calendar month shall not be considered as property substantially identical to another commodity future requiring delivery in a different calendar month".[20]

The Wash Sale Rule

A taxpayer other than a corporation, who is not either (1) a dealer in securities or (2) although not a dealer in securities is in the business of buying and selling securities, and a corporation which is not a dealer in securities may not deduct a loss on the sale of stocks or securities if within a period beginning 30 days from the date of the sale and ending 30 days after such date, he has acquired (by purchase or by an exchange on which the entire amount of gain or loss was recognized by law), or has entered into a contract or option so to acquire, substantially identical stock or securities.[21] The purpose of this provision is to deny the taxpayer a deduction for a loss for income tax purposes where, by a purchase which offsets the sale, he has had no realized economic loss. The disallowed loss, with appropriate adjustment for the difference between the proceeds of the sale and the offsetting purchase, is added to the basis of the offsetting purchase.[22]

This rule sometimes works a hardship. To illustrate: A taxpayer purchases 100 shares on March 1 and a second 100 shares on March 3. Within 30 days of the second purchase, he makes a sale at a loss and delivers the certificate representing the first purchase. The loss will be disallowed for the reason that the second purchase, even though not made in anticipation of

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17 Sec. 117(1)(3)(B)(iii) I.R.C.
18 Sec. 117(1)(I)(B) I.R.C.
19 Sec. 117(1)(3)(A) I.R.C.
20 Sec. 117(1)(3)(B)(ii) I.R.C.
21 Sec. 118 I.R.C.
22 Sec. 113(a)(10) I.R.C.

the sale, is an offsetting purchase within the wash sale rule. If the sale had been made more than 30 days after the first purchase and the certificate representing the second purchase had been delivered, the loss would be allowed, since there would be no offsetting purchase within the thirty-day period. If 200 shares are purchased on one day and a 100 shares sold within 30 days, a strict application of the law would seem to require the disallowance of the loss. However, it is the writer's experience that the taxing authorities allow the loss in such cases on the theory that there can be no offsetting purchase where the security remaining in the hands of the taxpayer was acquired in the same transaction as the security sold.

The wash sale rule is not applicable where the offsetting purchase is of a "similar" but not of a "substantially identical" stock or security. The taxpayer may sell Kennecott Copper stock and buy Anaconda Copper stock. There is risk to the advisor who recommends the making of such a "switch." It has never failed but that, when a taxpayer has acted on the writer's recommendation to sell Kennecott and buy Anaconda, the market price of Kennecott has immediately gone up and that of Anaconda has immediately gone down.

Sales to Related Taxpayers

Any attempt to avoid the application of the wash sale rule by having the offsetting purchase made by a related taxpayer is fraught with danger. The tax law[23] prohibits any deduction for losses on sales of property directly or indirectly between taxpayers having certain relationship with one another. It has been held that where a taxpayer sold in the open market and the related taxpayer bought in the open market within a few days of the sale by the taxpayer, there was an indirect sale to the related taxpayer.[24] If a loss is disallowed as a sale to a related taxpayer, the disallowed loss does not add to the basis of the offsetting purchase.

Sales at a Profit

Under certain circumstances the taxpayer may make a sale at a profit without incurring any tax liability—for example, where he has a capital loss carry-over which will expire in the taxable year and which would otherwise be wasted. If he does not desire to lose his position in the security, he may make a purchase of the security he has sold and thus own the security at a higher basis. The wash sale rule does not apply to sales at a profit and therefore the offset purchase may be made within 30 days of the sale. However, if the security is sold and repurchased from the vendee by prearrangement, it is quite likely that the stepped up basis will be disallowed on the ground that there was no bona-fide sale.

Certain Tax Sheltered Investments

There are corporations which are currently operating at a profit and which are distributing all or part of such profits to its stockholders but whose income tax history is such that the distributions are not taxable to the stockholders as dividends. This anomalous situation exists because of the definition of "dividend" in the tax law.[25] A distribution by a corporation to its stockholders is not a dividend unless (with certain exceptions applicable to personal holding companies) it is made out of (a) earnings or profits accumulated since February 28, 1913, or (b) out of earnings or profits of the taxable year. If a corporation has sustained losses prior to the taxable year which have offset accumulated earn-

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[23] Sec. 24(b)(1) I.R.C.

[24] *McWilliams et al.* v. *Comm.*, (1947) 341 U.S. 694 and *Comm.* v. *Kohn et al.*, 158 Fed. 2d, 32.

[25] Sec. 115(a) I.R.C.

ings and it has no earnings and profits for the taxable year, its distributions will not be dividends. A corporation may be operating currently at a profit and yet have no earnings and profits for the taxable year because it has taken losses on the sale of assets. There are a number of public utility holding companies and a limited number of industrial companies which (a) have no accumulated earnings and (b) have high priced holdings which can be sold at a loss to offset current income and which are thus able to make tax free distributions.

There are outstanding corporation bonds on which the interest is being currently earned. Because the interest was not earned in the past and payment thereof not made, payments now by the debtor corporations out of current earnings are being applied to pay past due coupons. Any amounts received in payment of interest accrued prior to the date of purchase of such bonds is not taxable as interest income but is a return of capital.[26] In some instances the amount collected on interest which accrued prior to purchase may exceed the cost of the bond. There is a difference of opinion among tax accountants as to whether, in such a situation, the excess is capital gain or ordinary income.[27]

The taxpayer may make certain that he does not receive ordinary income by selling the bonds before the collections on back interest exceed his basis and pay his tax on the resulting capital gain. He may make a new purchase and, assuming that the sale is bona-fide, he will be permitted to collect tax-free the interest accrued on the bonds at the time of the second purchase.

Conclusion

Because of the limitations on its length, this paper covers only a few of the income tax problems of investors in securities. Other problems, such as the determination of the holding period and the identification of the security sold, particularly warrant study by the tax-conscious investor.

[26] *Erskine Hewitt*, 30 BTA 962.

[27] The question to be answered is "Is the payment of past due interest a 'retirement' falling within Sec. 117(f) I.R.C.?"

Stock Options to Executives and Employees

By PHILIP BARDES, C.P.A.

PRIOR to the enactment of Code section 130A by the Revenue Act of 1950, the use of employee stock option plans as an incentive device was sharply impeded by the Treasury's position on this subject. The Treasury held that the difference between the option price and the fair market value of the stock when the option was exercised constituted compensation to the employee in the year that the purchase was made. It maintained this position regardless of whether or not the granting of the option was motivated by an intent to compensate the employee.

The Treasury took this stand following the Supreme Court's decision in *Commissioner* v. *Smith* (324 U.S. 177) on February 26, 1945. There is considerable doubt as to the validity of the regulations, which clearly went beyond the *Smith* decision. But whether valid or not, they effectively curtailed the use of stock options. Corporate executives could not afford the risk of having to pay the tax on the transaction at the very time that cash was needed to pay for the stock itself.

Congress Passes New Law

To mitigate the harsh effects of the Treasury's position, Congress provided new rules in the 1950 Act which liberalized the treatment of "restricted stock options."

Under the new provisions no tax is imposed at the time of exercising an option, and the gain realized upon disposition may be taxable in whole or in part as a long-term capital gain, if certain conditions are met.

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Definition in the Code

A restricted stock option is defined by the Code as one granted, after February 26, 1945, to an individual, for any reason connected with his employment. The grantor may be either his corporate employer or its parent or subsidiary corporation. The stock involved may be that of any of these entities. The parent or subsidiary relationship is determined, for this purpose, by ownership of more than 50% of the voting power.

Conditions Imposed by the Code

The Code imposes the following conditions for qualification under Section 130A.

1. The option price must be at least 85% of the fair market value of the stock at the time the option is granted.
2. The option must not be transferable except by will or by intestate succession.
3. The option can be exercisable only by the grantee during his lifetime.
4. At the time the option is granted the grantee must not own, directly or indirectly through certain relatives, more than 10% of the voting stock of his employer or of its parent or subsidiary corporation.
5. The new rules apply only if the option is exercised after December 31, 1949.
6. The grantee must either still be in the employ of the grantor when the option is exercised, or he must exercise it within three months after the termination of the employment.
7. The stock must not be disposed of within two years from the date the option was granted.
8. The stock must not be disposed of within six months from the date of transfer of the stock to the employee pursuant to his exercise of the option.

If all of the above requirements are met, no income will be taxable to the

employee at the time he exercises the option.

In such a case no deduction is allowed at any time to his employer or its parent or subsidiary company with respect to the stock sold by it.

There are two classes of options described by the statute, each of which receives different tax treatment at the time the stock is disposed of by the employee.

First Class of Options

The first class of options is those which are set at 95% or more of the stock's value when granted.

Here, the entire difference between the option price and the sales price is taxable as a long-term capital gain or loss. No ordinary income is recognized if all of the statutory requirements have been met.

Second Class of Options

The second class is those options which are priced at 85% to 95% of the stock's market value when granted. In these cases there is included in the employee's ordinary income in the year he disposes of the stock the amount by which the market value of the stock at the time the option was granted exceeded the option price.

If the amount received upon disposition is less than the value at the date of granting the option, however, the employee is taxed only for the excess of the sales price over the option price.

If the employee dies with the stock unsold, the difference between market value and option price is taxable to him in the year of his death.

It follows logically, with respect to this class of options, that the amount taxed to the employee as ordinary income is added to the original cost of the stock in computing his adjusted basis.

He will then report as a long-term capital gain the excess of the sales price over his adjusted basis.

Examples of Two Classes of Options

What the foregoing means taxwise to the executive can best be shown by an example. Suppose that Mr. Jones receives a restricted stock option to purchase 1,000 shares of his company's stock at a time when the stock is worth $20 per share. The option price is $19.50 per share, which is more than 95 per cent of the value of the stock. Mr. Jones exercises the option, paying $19,500 for his stock. Subsequently, more than two years after the option was granted and more than six months after the transfer of the stock to him, he sells the stock for $23,500. Under section 130A, Mr. Jones realized no income when he exercised the option; and his $4,000 gain on the sale of the stock is a long-term capital gain, subject to a maximum tax of 26 per cent.

If the option price had been $18.50 per share (between 85 and 95 per cent of the stock value) there would be included in Mr. Jones' income as compensation in the year of the sale the difference between the option price and (a) the selling price of the stock or (b) the value of the stock at the time the option was granted, whichever is smaller. In this case the option price was $18,500; the selling price of the stock was $23,500; and the value of the stock at the time the option was granted was $20,000. Therefore Mr. Jones realizes ordinary income on disposition of the stock of $1,500, the difference between the option price and the stock value at the time the option was granted. His basis, $18,500, is increased by this amount to $20,000, so that on the sale he realizes a long-term capital gain of $3,500.

Stimulation by New Law

There is no question that the enactment of the new provisions has greatly stimulated the use of stock options as an incentive device. The Wall Street Journal, on August 6, 1952, reported that approximately 300 major corporations have adopted stock option plans

since the new provisions were enacted. It stated further that more than 100 leading companies have adopted such plans during 1952 alone.

There are a number of practical problems connected with the use of restricted stock options.

Date of Granting Option

One problem which, happily, has been clarified by new legislation and the regulations, relates to the determination of the date on which the option was granted.

This date is important in several respects. For example, the 85% clause relates to market value on this date. The 10% stock ownership limitation is effective on this same day, as is the parent-subsidiary status. In addition the two-year period during which the stock may not be sold is measured from this date.

The Revenue Act of 1951 provided that where an option is granted by the board of directors, subject to stockholder approval, the effective date of the option is that on which the board of directors acted.

Similiarly, the regulations provide that where an option is subject to approval by a regulatory or governmental agency, the effective date is the one on which the directors approved it. An exception is made only if the corporate action clearly indicates a contrary intention.

The regulations also make it clear that even though an option cannot be exercised until some future date, the effective date is still that of the original grant.

Date of Exercising Option

Another important date to be determined is that on which the option was exercised. This affects the employment requirement as well as the determination whether an option was actually exercised by the employee during his lifetime.

The regulations provide that the term "exercise" means the act of acceptance by the employee of the offer to sell contained in the option. The time of exercise is stated to be the date on which there is a sale or a contract to sell.

The question whether an option has been exercised may arise where a conditional agreement exists. For example, suppose that under the company's plan the employee has the right to turn back the stock at cost if he leaves its employ.

The regulations contain the following sentence: "An agreement or undertaking by the employee to make payment under a stock purchase plan does not constitute the exercise of an option so long as the payments made remain subject to withdrawal by the employee."

While this provision may apply only to a case where an employee has made payments for stock not as yet delivered to him, it may be advisable to avoid any provision in the plan under which the employee could return the stock and get his money back after a formally designated exercise of the option.

Date of Transfer of Stock

Another practical problem is the determination of the date of transfer of the stock to the employee. This consideration arises out of the six months holding period requirement contained in the statute.

This question may arise in connection with the financing arrangements which may be made to assist employees in paying for their stock. In a number of corporate plans it is contemplated that the company will offer some direct assistance to the employee. The corporation may advance the purchase money to the employee or accept his note in payment. Interest on the employee's obligation might be set at a low rate, perhaps that which the corporation pays on its own indebtedness.

Dividends may be used to reduce the principal amount of the debt as well as to meet the interest payments. Or the plan may provide for definite payments on the purchase price either directly or through salary deductions, or both.

On the subject of the effective date of transfer, the regulations state that the transfer of stock means "the transfer of ownership of such share, or the transfer of substantially all the rights of ownership."

In a case where the employee has no voting rights and no dividends are paid on the stock until the full purchase price has been paid, it would probably be ruled that no transfer had taken place as long as these rights were withheld.

On the other hand, where the employee has all of the usual rights but the stock is held as collateral for payment of the purchase obligation, it would seem that the employee has received "substantially all the rights of ownership," and that a transfer has taken place.

Unquestionably, however, there exists a considerable amount of uncertainty in this area, and it would be well for corporations contemplating financial arrangements of the types described to obtain an official statement of Bureau opinion with respect to the effective time of transfer under their plan.

When a purchase plan is agreed upon, it should be adhered to if at all possible. Under the regulations a material change in the terms of payment for stock may be regarded as a modification of the option. This then would be considered as the grant of a new option to the employee.

Determination of Fair Market Value

There is one aspect of section 130A which might easily be overlooked at first glance, but which could turn out to be the most vexing of all. That is the determination of the fair market value of the stock offered to the employee.

In the case of a listed corporation there is no difficulty. The employee can simply open a newspaper and see what the stock is worth on the Exchange.

But what about the smaller, closely held corporation? All tax practitioners know how difficult it is to value such stock, and how much variation there can be between two equally well informed opinions on the subject. As long as the Treasury declines to issue advance rulings as to these values, the smaller, closely held companies will be unfairly deprived of an equal opportunity to make use of stock option plans.

Deduction by Corporation

In the usual course of events, the corporate employer will seldom be permitted any deduction upon the exercise of a restricted stock option. However, if all of the conditions of the statute are not complied with, the corporation would be entitled to a deduction for the same amount as that taxable to the employee.

The right to the deduction might arise in any one of several ways, so it is important that the corporation keep up to date on all transactions affecting the optioned stock. The death of an employee who has not exercised his option and the subsequent exercise of the option by his estate would be an example of a case apparently giving rise to an allowable deduction to the former employer.

Consideration for the Option

A discussion of restricted stock options would hardly be complete without some reference to the problem presented by the *California Eastern Airways* decision, handed down by the highest court of Delaware, on July 17, 1952.

The court held that certain options were invalid under state law because of insufficient consideration for the granting of the options. The plan provided no definite assurance, through a contract of employment or otherwise, that the executives involved would remain in the company's employ.

Where the problem presented by this decision exists, caution should be exercised in adopting steps designed to remedy the situation. If there has been

a substantial appreciation in the market value of the optioned stock, making a new option agreement that embodied the terms of the consideration would result in the option price having to be adjusted upward so as to be in line with the appreciated value of the stock.

The question arises whether a supplemental agreement, merely setting forth the terms of the consideration under an existing option, would constitute a modification of the option. If so, this would be equivalent, under the statute, to granting a new option.

The regulations state that "a modification of an option includes any material change in the terms or conditions of the option." The examples given clearly reflect the view that "modification" relates to a change either in the kind or price of the shares offered, or with respect to the time or manner of exercise, delivery or payment for the stock. It would seem, therefore, that the execution of a supplemental agreement setting forth the consideration involved, should not result in the granting of a new option under the regulations. As yet, however, there has been no expression of Bureau attitude on this question.

Alternatives to Stock Options

The attractiveness of the stock option as an incentive device should not foreclose the exploration of other possibilities which could prove highly advantageous. For example, a corporation might sell stock to an employee at a price considerably below its normal market value, at the same time imposing certain restrictions on the sale of the stock by the employee for a given period of time. The company could retain the right to buy the stock back at cost if the employment relation were terminated within the specified period.

If the restrictions imposed on the stock are such as to deprive it of a fair market value at the time of purchase, the individual realizes no income at the time he acquires the stock.[1] Moreover, no income is realized at the time the restrictions expire since the lapse of such restrictions has been held not to constitute a taxable event.[2] Only upon the ultimate disposition of the stock is a capital gains tax imposed. The Bureau has indicated its acquiescence in both the *Kuchman* and *Lehman* decisions.

[1] *Harold H. Kuchman*, 18 T.C. 154.
[2] *Robert Lehman*, 17 T.C. 652.

Plans for Deferring Compensation

(Other than Pension and Stock Option Plans)

By LOUIS WINSTEN, C.P.A.

THE successive increases in tax rates by Congress for the past few years have caused many corporations and their executives to review the methods of compensating executives. The problem, basically, is that, because of the impact of income taxes, an increase in gross compensation usually has very little beneficial effect dollar-wise for the executive employee. Assuming that the executive is in a high tax bracket, an increase that is substantial, at least on its face, would in all probabilities be reduced to an insignificant amount after taxes. For example, a married person with two dependents earning $50,000.00 (using the maximum standard deduction of $1,000.00) would retain out of an immediate $10,000.00 annual increase only $3,300.00, as he would then be in a 67% tax bracket. Thus, in the current inflationary period with the cost of living rising steadily, many of these executives find themselves in the unenviable position of being unable not only to meet the immediate demands of the high cost of living but to accumulate sufficient funds for retirement or other purposes.

The desire for old-age security has been evinced by even the highest paid executive. As our security-consciousness increased, the corporate executive has become more and more concerned with the problem of retirement and accumulation of sufficient funds to be able to live comfortably. The fact remains that even a comparatively large increase would leave little to accumulate because of the large surtaxes imposed upon such increase.

As a result, certain plans have been formulated and instituted in the attempt to overcome this problem and negate, at least partially, the economic effect of high taxation. These plans may be categorized as follows: commercial annuity and life insurance contracts, profit-sharing and pension plans, stock options and purchase plans, other deferred compensation or salary continuance plans and payments to the surviving spouse or the estate of the deceased employee. Compensating executives through profit-sharing and pension plans and stock options are subjects for other papers and hence are not covered herein.

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Commercial Annuity and Life Insurance Contracts

The first of the plans to be considered is the purchase of commercial annuity contracts and life insurance contracts. Under these plans, the company purchases a commercial deferred annuity contract with payments to be made each year for the executives so covered. Or the company can pay the premiums of life insurance taken out on the life of the employee. However, these plan do not offer satisfactory solutions to the problem because of the unfavorable tax treatment.

Under the Internal Revenue Code, the premiums paid on a life insurance contract on the life of the executive in which the employer is directly or indirectly a beneficiary under such policy

are not deductible by the employer.[1] In such case, the premiums do not constitute taxable income to the employee. In the event the corporation is not in any way the beneficiary and the executive is permitted to name the beneficiaries of the policy, the premiums paid contitute taxable income to the employee.[2] This, of course, is subject to the rule that, to be deductible, total compensation must be reasonable. Even where the employee may not name the beneficiary, the premiums paid constitute ordinary income to the employee.[3] The employer will be entitled to a deduction where the employee is deemed to have received taxable income.[4] In the event a qualified exempt trust under Section 165 purchases a life insurance policy for an employee, the premiums paid for such life insurance protection from contributions from the employer or earnings thereon will constitute taxable income to the employee.[5]

As an alternative, the employer may purchase a commercial deferred annuity contract. The employer may not deduct the premiums paid if the employee's rights are forfeitable at the time contributions are made.[6] To be non-forfeitable, there must not be any contingency under the plan which may cause the employee to lose his rights in the contribution.[7] If the employee's rights are non-forfeitable, the premiums paid constitute taxable income to him. Assuming that the contract was either non-assignable or had no cash surrender value, would taxable income result where the employee's rights were non-forfeitable? In *Hacket* v. *Commissioner,*[8] the policy had no cash surrender or loan value. The court there held that the premiums paid were nevertheless includible in the income of the employee.

The test is non-forfeitability at the time the contributions are made. In the recent case of *Morse* v. *Commissioner,*[9] the petitioner's employer purchased a single-premium annuity contract based on the petitioner's life. Petitioner acquired no rights under this contract until endorsement was made to him by the employer in 1943, two years later. The contract was nontransferable and had no cash surrender or loan value. In a decision reviewed by the Tax Court it was held that the petitioner realized taxable income on the value of the policy in 1943. This value was the cost to the employer less the amount of recoveries received by the employer in the intervening period. The court construed the employer's contribution referred to in Section 22(b)(2)(B) to mean amounts paid over by the employer for the benefit of his employee at the time of endorsement in 1943.

It therefore is apparent that the above plans are unsatisfactory. Where the employee is deemed to have received taxable income, his immediate problem still remains. In fact, it may become even more acute as the amount is designated and earmarked for a specific expenditure and taxes are payable on premiums that may not be presently realizable in cash. Where the employee is not deemed to have received taxable income, the employer will be denied the deduction. Furthermore, this deduction is lost forever.[10]

Before closing, it should be added that premiums paid by the employer on policies of group life insurance cover-

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[1] I.R.C., Section 24(a)(4).
[2] O.D. 627, 3 CB 104; *G. M. Adams,* 18 BTA 381, 11/29/29.
[3] G.C.M. 16069, XV-1 CB 84.
[4] G.C.M. 8432, IX-2 CB 114.
[5] Regulations 111, Section 29.165-6 (Third Paragraph).
[6] I.R.C., Section 23(p)(1)(D).
[7] Regulations 111, Section 29.165-7 (First Paragraph).
[8] 159 F.(2d) 121, 12/18/46 (1st Circuit), affirming 5 TC 1325; I.R.C., Section 22(b)(2)(B).
[9] 17 TC, No. 150, 1/28/52 (Taxpayer appealed to CCA-2, 5/28/52).
[10] Regulations 111, Section 29.23(p)-11.

ing the lives of his employees are not income to the employees even where the employees have the right to designate the beneficiaries.[11] Group life insurance should be distinguished from group-permanent life insurance which may have paid-up values or other benefits. These permanent contracts result in income to the employees as to the premiums paid on such contracts.[12]

Deferred Compensation Contract Plan

The next plan for consideration is the deferred compensation contract plan or the salary continuance plan. Briefly, the plan operates as follows:

An executive and the employer agree in a contract for a certain amount of compensaton to be paid annually for services rendered the corporation and, at the same time, provide for amounts to be paid after retirement. Usually provision is made that in the event of the death of the executive before a certain number of years have elapsed, payment of a specified amount is provided for to the beneficiaries of the executive.

It is apparent by the use of this plan that a portion of the executive's compensation is deferred to a later period. This therefore allows a more even spread of annual income and assures the executive of a retirement allowance and possibly a death benefit payable to his beneficiaries.

You may be aware of the so-called Milton Berle contract. Such contract has been reported in various publications. According to these articles, the National Broadcasting Company (the employer) gave Milton Berle a new contract for a term of thirty (30) years at $50,000.00 a year. For the first five years, Mr. Berle will perform for a given number of weeks; for the next five years, he will perform for a lesser number of weeks; for the second ten-year period, his sole obligations are to serve as a consultant or director and for the final ten-year period, no services are required.

Under this arrangement, Mr. Berle would report as taxable income only the amounts actually received. The corporation employer would deduct the amounts paid as expenses for the period in which paid. It is, therefore, obvious that under this arrangement, the income is deferred, but with the employer entitled to a deduction at the same time.

Of course, this meant an immediate drop of current income to Mr. Berle as he had been reputed to have earned a five-figure amount per week or performance. But with personal income tax rates at a very high level, the loss is not as severe as it would appear to be at first glance. Mr. Berle has, through the above contract, assured himself of a high income for, at least, a substantial part of his remaining natural life. Furthermore, this contract should be looked at from the point of view that Milton Berle's popularity may fade, or terminate, within the term of the contract. But, N.B.C. is still obligated to pay the $50,000 annually.

There are two important tax doctrines which the Commissioner may raise in the attempt to tax such deferred income, not in the year received, but rather in the year earned. These are the constructive receipt doctrine and the "equivalent of cash" doctrine.

Constructive Receipt Doctrine

The constructive receipt doctrine has been formulated to prevent a cash receipts taxpayer from being able to report his income in the year he wishes. It is found in Regulations 111, Section 29.42-2, with examples of what constitutes constructive receipt in Section 29.42-3. The Commissioner has attempted to invoke this doctrine as to the deferred compensation plan in several cases, but without success.

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[11] Regulations 111, Section 29.22(a)-3.

[12] Mimeograph 6477, 1950-1 CB 16.

In the *Howard Veit* cases[13], the petitioner was employed on a fixed salary plus a percentage of profits. The petitioner entered into several new contracts extending the time for payment of his share of the profits. The 1940 percentage of profits was originally to be paid in 1941, then in 1942 and finally to be paid in 1942 and 1943. The Commissioner contended that it was reportable as income in 1941. In the second case, the 1941 percentage of profits originally payable in 1942 was finally agreed to be paid in five annual installments beginning in 1943. The Commissioner likewise contended that it was all reportable as income in 1942. In both cases, the same arguments were advanced by the Commissioner, with the additional argument in the second case that at the time the new arrangements were entered into, the profits were known. The Tax Court stated in both cases that the new contracts were entered into at arm's length and that there were sound business purposes, for these new arrangements. It held that at no time were the profits unqualifiedly subject to the employee petitioner's demand or withdrawal, that the petitioner did not voluntarily refrain from collecting money available to him nor did he agree to the employer's deferred payment of moneys available when the agreement was made. It further held that there was no constructive receipt of such percentages of profits as petitioner was on the cash basis. It should be noted that the corporation employer was on the accrual basis and accrued these amounts as deductions. The court followed the decision rendered in the *Kay Kimbell* case.[14]

The above holdings were relied on in the *J. D. Amend case*.[15] In this case, the petitioner (a farmer) contracted to sell a portion of his wheat in one year and receive payment in the following year. This was a consistent practice followed by the petitioner for several prior years. The Tax Court found that the contracts were made at arm's length, were bona-fide, and that the petitioner could not obtain payment prior to the date stated in the contract. There was no constructive receipt of the income in the year of the sale though the Commissioner contended that the wheat could have been sold for immediate cash payment.

In the case of *James F. Oates* v. *Commissioner*,[16] the petitioners, who had retired as general agents of an insurance firm, had elected irrevocably, prior to retirement, to take the commissions on renewal premiums, to which they were entitled, at the rate of $1,000.00 a month for a period of fifteen years, instead of receiving such commissions when earned. The Commissioner contended that the renewal premiums were income to the petitioners in the year earned and not when received in cash. The Tax Court, following the *Veit* cases, held that the petitioners were not entitled to receive any more than they did in fact receive and that, being on the cash basis, they can only be taxed on these amounts and that the remainder will be taxed to them if and when received by them.

It would appear from the above that the Commissioner could not use the constructive receipt doctrine to tax deferred compensation income when earned. If the contract entered into is bona-fide, made at arm's length, and is a binding obligation, the Commissioner should not be allowed to prevail. Of course, if the contract was merely a sham and a subterfuge for the purpose of enabling the executive to postpone his income tax on the amounts earned to another year, a different situation would probably prevail.[17]

Just one word of caution. If there should be a similar set of facts as were present in the *Veit* cases, but the em-

[13] 8 TC 809, 4/14/47 (Acq.); T.C. Memo Opinion, 10/11/49, 8 TCM 919.
[14] 41 BTA 940, 4/25/40.
[15] 13 TC 178, 8/8/49.
[16] 18 TC, No. 69, 6/20/52.
[17] See *Howard Veit (supra note 13)* 8 TC, at page 816.

ployee is more than a 50% stockholder, directly or indirectly, you must be aware of the dangers and pitfalls of Section 24(c) of the Code. If 24(c) should apply, payments must be made within two and one-half months after the close of the taxable year. If the payments are not made within this time period, the deduction will be disallowed not only for the taxable year involved, but for all years.

Equivalent of Cash Doctrine

The Commissioner may claim that the taxpayer has received economic benefit in the year in which the services were rendered to the extent of the amount of compensation deferred. This is known as the "equivalent of cash" doctrine, which finds its roots in the Supreme Court opinion rendered in *Commissioner* v. *Smith*,[18] in which it was held that the excess in value of the shares of stock over the option price whenever the option was exercised was compensation to the employee under Section 22(a) of the Code[19] since such section "is broad enough to include in taxable income any economic or financial benefit conferred on the employee as compensation, whatever the form or mode by which it is effected." In another case,[20] the Tax Court held that the taxpayer received income in the year an annuity contract was received and not many years previous when his rights vested in the original employment contract.

In a deferred compensation arrangement, it is the cash basis taxpayer who would be affected by any Commissioner action. A cash basis taxpayer should return as taxable income only those amounts actually received. This principle is deeply rooted in our income tax system. Here the employee has received only a promise to pay in the future, which promise should be nontaxable. In one case,[21] the Court said that it is "absurd to speak of a promise to pay in the future as having a market value". In another case,[22] the Circuit Court of Appeals reiterated the doctrine that a cash basis taxpayer can not be deemed to have realized income at the time a promise to pay in the future is made.

Conclusion

The deferred compensation plan has many advantages. It allows an executive to be guaranteed a substantial income for life or a certain fixed period usually after retirement or the reaching of a certain age. It is believed, and the cases support such belief, that he will be taxed only on the amounts when received. The company will be permitted to deduct the amounts paid in the year in which paid. This would have the effect of putting an accrual basis company on the cash basis relative to such deduction.

It may be advisable to attach some conditions to the plan as a precautionary measure to prevent the Bureau from taxing the income when earned. Examples of such conditions are:

1) Consultation or advisory services after retirement.
2) Covenant not to compete after retirement.
3) Rendering of services up to retirement.
4) Amount to be received on retirement wholly contingent on employer's profits.

These are only a few examples. There may be others which will fit the particular situation. Without them the Commissioner might hold that the employee has acquired a vested right

18 324 US 177, 2/26/45.

19 Also, refer to Regulations 111, Section 29.22(a)-1.

20 *W. E. Freeman,* 4 TC 582 (1/16/45). See also *R. R. Deupree,* 1 TC 113, 11/24/42; and *R. K. Brodie,* 1 TC 275, 12/16/42.

21 *Bedell* v. *Commissioner,* 30 F.(2d) 622, 2/4/29.

22 *Perry* v. *Commissioner,* 152 F.(2d) 183, 12/13/45.

in the compensation to be paid upon conclusion of the services and attempt to tax the employee on such balance at such time.

Payments Made to Beneficiaries of Deceased Employees

There is one more point that should be mentioned in this paper; and, that is, payments made to beneficiaries of deceased employees.

Under the former Bureau ruling,[23] it was held that if there was no obligation of the company to make any payments to the widow of a deceased employee, such payments did not constitute taxable income to the recipient. This was on the theory that the payments constituted gifts. Under this rule, these payments could only be made for a limited period.[24] In one case, such period was held to be limited to twenty-nine months.[25]

In 1950, the Bureau promulgated I. T. 4027[26] which modified the above former ruling to the effect that such payments are taxable income to the widow if they are made in consideration of services rendered by the deceased employee. This is applicable to payments made after December 31, 1950.

Under the regulations, the payments made are deductible by the employer if paid for a limited period after the death of the employee.[27]

There is some question of doubt if the courts will go along with the Commissioner's new ruling. The question should be one of intent—was a gift intended to be made? To date, there are no cases with the new rule in issue.

In *MacFarlane* v. *Commissioner*,[28] the widow received a payment of the bonus which the husband, had he lived, would have received. This was the first instance in the company's history that a bonus had been paid after the employee died. The court held that the payment was a gift and therefore not income to the widow. As the payment was made prior to January 1, 1951, the Bureau's new ruling was not in issue. This may be an indication of what the court will say when the new ruling is considered in future litigation.

The Revenue Act of 1951 amended Section 22(b)(1) of the Code.[29] Where a contract legally obligates an employer to pay a death benefit to the employee's beneficiaries, such payments do not constitute taxable income to the employee, to the extent of $5,000.00 received from one employer. In the event several beneficiaries are entitled to a portion of the death benefits, the exemption is to be allocated amongst them.

If there are a group of affiliated corporations with a common employee, each corporation could pay $5,000.00 to the beneficiaries without the latter incurring any tax liability.

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[23] I.T. 3329, 1939-2 CB 153.
[24] *W. D. Haden Co.*, T.C. Memo Opinion, 4/9/46, 5 TCM 250.
[25] *McLaughlin Gormley King Co.*, 11 TC 569, 10/11/48. Cp. *I. Putnam, Inc.*, 15 TC 86, (Acq.) 8/3/50, where the limited period was held to be 24 months.
[26] 1950-2 CB 9.
[27] Regulations 111, Sec. 29.23(a)-9.
[28] 19 TC, No. 2, 10/9/52.
[29] Sec. 302, Revenue Act of 1951.

Spin-Offs and Problems Incident to Corporate Liquidations

By HARRY JANIN, C.P.A.

Spin-Offs

A spin-off is a form of tax-free reorganization provided by Code Section 112(b)(11) added by the Revenue Act of 1951. A spin-off occurs when a part of the assets of a corporation is transferred to a new corporation and the stock in the latter is distributed to the shareholders of the original corporation without a surrender by the shareholders of stock in the distributing corporation. A split-off is the same as a spin-off except that the shareholders of the distributing corporation surrender some of their stock in that corporation for stock of the new corporation. A split-up occurs when a corporation transfers all of its assets to two or more new corporations and dissolves, and the stock of the new corporations is distributed to the shareholders of the old corporation.

The spin-off provisions will apply only if there is a plan of reorganization and if the new corporation issues only common stock. Further, the parties must intend that the new corporation as well as the parent must continue the active conduct of a trade or business after such reorganization. The benefits of the section will not be allowed if the reorganization was principally a device for the distribution of earnings and profits of the corporations which are parties to the reorganization.

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The new spin-off provisions are applicable to taxable years ending after October 20, 1951, provided the distribution is made after that date.

If the spin-off qualifies, then the basis of the old stock in the hands of the shareholder must be allocated between the new stock and the old stock pursuant to regulations to be prescribed.

At this writing, the regulations have not been issued and no aid or comfort can presently be obtained in ascertaining what will constitute "the active conduct of a trade or business" or what will be "a device for the distribution of earnings." However, some light is cast by the Senate Finance Committee report which points out that the assets spun off may be stock of another corporation. In that case, of course, the new corporation will merely be a holding company owning the stock of another corporation and inferentially mere ownership of such stock will be considered "the active conduct of a trade or business." However, business reasons must exist, unrelated to any desire to make a distribution of earnings to shareholders, for the separation of the assets consisting of such stock.

Corporate Liquidations

Ordinarily, a corporation realizes no gain or loss upon the distribution of its assets in complete liquidation and its shareholders realize capital gain or loss from such distribution. There are a number of apparent statutory exceptions, for example, the collapsible corporation and the liquidation under Code Section 112(b)(7). However, there are others which are not readily apparent.

Liquidations Which May Qualify as a Reorganization

There are times when a taxpayer desires a taxable liquidation in order to obtain a stepped-up basis for assets. Such a situation might occur, for example when A acquires all of the stock of Corporation B and liquidates the corporation because the corporate basis of the assets is considerably less than the purchase price of the stock. As long as A retains the assets in his own name, he will have his stepped-up basis, but if he transfers the assets to a new corporation, the effect of the liquidation and transfer is a reorganization under Code Section 112(g)(1)(C) or 112(g)(1)(D). If all of the assets are transferred, no gain or loss will be recognized to either A or B but the new corporation will be required to take the basis in the hands of B. Furthermore, if less than all of the assets are transferred, i.e., A may retain surplus cash, then A, if he has a gain from the transaction, may incur a tax as a dividend to the extent of the available earnings of B but not in excess of the cash received.

Distribution of Installment Obligations

Under Code Section 44(d), the liquidating corporation realizes gain upon the distribution of installment obligations measured by the difference between a fair market value of the obligation at the time of such distribution and the basis of the obligation in the hands of the distributing corporation. By installment obligation, of course, is meant an obligation received pursuant to a sale of property which is reported for tax purposes on the installment plan.

The statute provides an exception to the foregoing rule if an installment obligation is distributed by one corporation to another in the course of a liquidation which qualifies under Code Section 112(b)(6). The regulations recognize another exception upon the transfer of an installment obligation by a corporation which is a party to a reorganization, in which case the transfer is tax free under Code Section 112(b)(4). Another exception recognized by the regulations is a transfer of an installment obligation to a corporation controlled by the transferor, Code Section 112(b)(5).

Distribution of Appreciated Assets

The distributing corporation should recognize no gain or loss upon distribution in complete liquidation to its common shareholders of assets which have appreciated in value. However, the shareholder may also be a creditor. In that event, care should be taken to see that the distribution of the assets will not be construed to be in payment of a debt. If it is, the distributing corporation will realize a taxable gain under the now familiar rule that the excess of the amount of a debt paid over the tax basis of the asset used to pay the debt constitutes gain.

A similiar problem occurs if appreciated assets are used to retire preferred stock. Although preferred stock does not constitute a debt, the payment to retire such stock is usually a fixed sum, i.e., par plus unpaid dividends. There appears to be no reason why the gain which may be realized upon the payment of a debt may not also be realized upon a retirement of preferred stock.

Liquidations Under Code Section 112(b)(7)

Gain upon liquidation of a corporation may be wholly or partly deferred if the liquidation is completed within any one month of a calendar year. The section does not apply to losses and by the specific terms of the statute may not be used after December, 1952.

If election is made and the liquidation qualifies, a non-corporate shareholder is required to pay a tax as a dividend on that portion of his gain equal to his ratable share of the liqui-

dating corporation's earnings and profits. If the corporation has no earnings and profits, then no portion of the gain is taxed as a dividend. Furthermore, if the shareholder receives in liquidation money or stock or securities which the liquidating corporation acquired after August 15, 1950, then the gain is taxed to the extent of such receipt, but in this latter case, there must first be deducted from the gain to be reported the shareholder's ratable share of earnings and profits which he is required to report as a dividend.

A corporate shareholder, if it has a gain, reports its ratable share of the earnings and profits of the distributing corporation or its share of the money, stock and securities acquired by the distributing corporation after August 15, 1950—whichever is higher—as a capital gain.

The section may be used to advantage if the liquidating corporation does not have any substantial amount of earnings and profits and does have assets which have appreciated in value. However, the election once made is irrevocable, and it therefore is very important to ascertain correctly the amount of accumulated earnings.

Under Code Section 113(a)(18), the property received in liquidation takes a substituted basis, i.e., the basis of the stock of the liquidating corporation reduced by the money received and increased by the gain recognized whether taxed as a dividend or as capital gain. Peculiarly, neither the basis section or the regulations issued thereunder make any provision for liabilities. Thus, if the only asset received upon liquidation of a real estate corporation which has no earnings is real estate subject to a mortgage thereon, a literal reading of the basis section would require the real estate to take as a basis only the basis of the stock in the hands of the shareholder. However, the Bureau has indicated informally that in such situations it will permit the face amount of the liabilities to be added to the new basis.

A Currently Significant Excerpt from the Paper of Mr. Arthur B. Moll

As a general rule a reduction of basis is required for depreciation, obsolescence and depletion to the extent that these items were allowed or allowable as deductions in computing net income. However, this general rule has been modified by Public Law 539, July 14, 1952, which is retroactive, at the taxpayer's election, to open taxable years beginning after December 31, 1938. The new rule provides that if, for any taxable year the depreciation "allowed" is in excess of the depreciation "allowable," the excess need be applied to reduce the basis only to the extent that the deduction of the excess reduced income or excess profits taxes for any year. This amendment was intended to correct the inequitable situation created by the decision in the *Virginian Hotel* case, but there still remains the problem of resolving the differences of opinion with the Commissioner as to just what amount of depreciation is "allowable." *You are reminded that the election under the new amendment must be made not later than December 31, 1952.*

The Tax Aspects of Pension and Profit-Sharing Plans

By Matthew F. Blake, C.P.A.

The constantly expanding employee benefits field is today making great demands on Certified Public Accountants. The planning and drafting of agreements in this field may require the services of attorneys, actuaries, insurance men and bankers, but even with this formidable group of specialists the public accountant can be of great assistance. His independent standing, his knowledge of clients' affairs and his alertness to business trends should render it imperative that he be consulted even though he is not a specialist in the field. He may start the machinery in motion by suggesting the inauguration of a plan or an amendment to an existing plan, and he should be prepared to provide a sound evaluation of the terms of a proposed plan. After the inception of the plan he will be expected to maintain contact with its accounting and tax ramifications and he should bear in mind the need for frequent re-examination in order to determine the adequacy of existing plans.

There are many reasons for establishing qualified retirement plans, such as: a) they tend to attract new employees and to bolster the morale of employees on the payroll; b) as accountants we should recognize that companies lacking retirement plans tend to understate the cost of employment by failing to recognize any provision for the eventual retirement of a number of employees; c) the numerous tax benefits available to employees; d) comparatively low net cost to the employer after taxes.

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The top effective tax rate, including franchise tax, is about 83%. Therefore, the net cost of a payment of $100,000 to a pension or profit-sharing plan would be approximately $17,000. If the company happens to be engaged in defense work with profits in excess of allowable levels in renegotiation, the cost for a given year could be as low as zero. Even when invested in Government bonds, a contribution should double itself, at compound interest, in somewhere between 25 and 30 years later. This increase is only possible where the trust is qualified as tax exemt under Section 165 of the Code. If the money should be invested in equities, the sum might accumulate more rapidly, as in the case of the *Sears Roebuck* plan. Aside from these tax advantages, the company will have provided its officers and employees with the protection and benefits which arise from a funded pension or profit-sharing plan.

Pension and profit-sharing plans are not shelf goods in any sense of the term. Each plan must be tailored individually so as to meet the needs both of employer and beneficiaries. Such matters as the relationship of employment costs to sales, the average age of employees, the relative stability of the business, etc., must be taken into account. We will discuss pension and profit-sharing plans concurrently where necessary and separately where possible. As there is a growing and salutary tendency to use profit-sharing plans either as substitutes for pension plans or as supplements to such plans, it probably would not be advisable to limit this discussion

to one or the other. This may lead to some confusion on the part of the reader. In this respect some indulgence on the part of the reader is requested because the general subject is about as difficult to present in brief form as any phase of tax law. Because of limitations of space, no attempt will be made to describe or evaluate the various types of plans in use; the difference between trusteed and non-trusteed plans also will be ignored unless the tax treatment differs.

Applicable Provisions of the Code and Regulations

There are three parts of the Code which are concerned directly with employee trusts. Section 165 is concerned both with the qualification of pension and profit-sharing trusts as tax exempt and the reporting of income by the distributees of such plans. Section 23(p) covers the deductibility of contributions to approved pension and profit-sharing plans and also embraces such matters as deductibility of contributions under non-approved plans, carry-overs, limitations, the accrual of contributions, etc. Section 22(b)(2)(B) governs the taxability of annuities stemming from both types of employee trusts.

Sole proprietorships, partnerships and corporations are all permitted to qualify plans under Section 165. As we public accountants realize all too well, sole proprietors and the members of a co-partnership are not includible among the beneficiaries of a qualified trust. It is possible for one plan to cover affiliated companies or members of an employee group drawn from a number of companies. A spectacular development in the field is the *Toledo Plan* covering members of the United Auto Workers Union employed by nineteen companies in the Toledo area. A feature of this plan is that coverage continues without change even though the individual transfers from one company to another.

The taxpayer should apply for a ruling on whether or not the proposed plan meets the requirements of Section 165. In general, Section 165 applies alike both to pension and profit-sharing plans. The restrictions imposed by the Wage and Salary Stabilization Boards should be kept in mind when drafting the plan. However, approval under Section 165 is the first step. A letter from the Treasury Department advising that a plan has met the tests provided in Section 165 usually will state that any deductions taken pursuant to Section 23(p) of the Code are subject to audit by the field examiner who will check the tax returns. It is prudent to establish a corpus for the trust within the taxable year for which the first deduction will be claimed and to have in effect by the last day of that year at least a tentative trust agreement.

The *Code* and *Regulations* set forth a series of rules for determining the eligibility of a trust under Section 165: 1) the plan may not permit discrimination with respect to coverage, contributions or benefits in favor of officers, shareholders, supervisors, and highly paid employees; 2) there must be a plan set up for distributing pensions or a share of profits to employees; 3) the plan must be for the exclusive benefit of the employees of the taxpayer; 4) it must be permanent (however, see comments on the *Lincoln Electric* case in the profit-sharing section hereof); the only acceptable reason for discontinuing a plan in the eyes of the Commissioner is business necessity; 5) the plan must provide definitely and affirmatively that no funds may be diverted to the employer before all liabilities, actual and contingent, have been satisfied; 6) in the case of a pension plan, the benefits payable or the amount of yearly contributions must be determined actuarially; for a profit-sharing plan benefits may not be predetermined on an actuarial basis; 7) the plan must be communicated to the employees so that they may determine their rights and privileges.

The *Code* and the *Regulations* do not distinguish clearly among the anti-discrimination rules for coverage, con-

tributions and benefits. In the hope of attaining simplicity by classification, an effort will be made to review coverage first and then to proceed to contributions and benefits. The reader should bear in mind that this treatment is arbitrary at best.

Coverage Standards

The Code states that if 70% of all employees are covered by the plan there is no discrimination as to coverage. If the plan falls short of meeting the 70% requirement, a calculation should be made to determine whether or not 80% or more of the employees who are eligible to benefit under the plan are covered. In that event, the coverage would be sufficient, provided 70% or more of all the employees of the company are included in the eligible group. In this latter determination, employees with less than five years experience, those who work less than twenty hours a week, and seasonal employees may be excluded.

If the coverage standards reviewed above are unsuitable in a particular instance, there are a number of restrictive classifications which may be used, provided that no discrimination results. Special approval from the Commissioner is required before any such coverage classifications may be utilized. They include the following: 1) employees whose compensation is less than $3,600 may be omitted; 2) the plan may be limited to salaried or clerical employees, or to the employees of a particular plant, office, or department; 3) where appropriate, a service period in excess of five years may be required for eligibility. This list is not exclusive, as the Commissioner has the power to approve other categories.

Contributions and Benefits Tests

The following are illustrative of the tests which are applied in determining whether or not discrimination exists with respect to contributions or benefits: 1) contributions to and benefits from a pension plan should bear a uniform relationship to compensation; this principle may be applied consistently even though it results in large pensions to highly paid officers and others; 2(a) where contributions or benefits of a pension or profit-sharing plan based on the first $3,600 of compensation are lower than for compensation exempt from the old age benefits tax, the total benefits under the plan and the law must be integrated; 2(b) employees whose wages do not exceed $3,600 may be excluded from coverage by a pension or profit-sharing plan, but only if the benefits under the plan are integrated with the schedule of benefits under the old age benefits tax; (use of such minimum compensation levels is limited, in the case of profit-sharing plans, to those which provide for benefits only on retirement or separation from employment—see *Mim 6641*); 3) the so-called *"30% rule"* which once hamstrung small corporations was revoked by the Commissioner when he acquiesced in the *Volckening* case (13 TC 723).

In general, benefits for officers, stockholders, etc., must be no higher in relation to compensation than for other employees. However, they may be lower without causing the Commissioner to suffer even the slightest pang of his official conscience. Where a plan calls for contributions by employees they may not be set so high as to discourage participation in the plan by lower-paid employees. In setting service, age and other requirements, care also must be exercised to steer clear of discriminatory practices.

Deductibility of Contributions

Although the deductibility of contributions depends to a great extent on whether or not the plan has been approved under Section 165, we must still look to Section 23(p) to see if the payments are, in fact, allowable as deductions. The contribution for each employee, when considered with all other forms of compensation, must be reasonable in amount as measured by the

criteria for Section 23(a) of the Code. This should not be interpreted to mean that the deduction may be taken either under Section 23(a) or Section 23(p). It may be claimed only under the latter. To the extent that the contributions for one or more individuals may be deemed excessive, they would be held non-deductible despite the fact that all other provisions of Section 165 and 23(p) have been met. Ordinarily, a question of reasonableness of contributions will arise in the course of an inquiry into the reasonableness of officers' salaries, and not as a separate issue.

Section 23(p) sets forth separate rules for pension and profit-sharing plans. The latter will be covered in the profit-sharing section of this article. Section 23(p), which certainly contains some of the most unintelligible language in the Code, sets up limitations on the amount which may be deducted in respect of a pension plan in any one year. Frequently, sub-sections (i) and (ii) thereof have to be read together. Sub-section (i) states that the amount deductible may not exceed 5% of the compensation otherwise paid during the year to all of the employees under the plan, and then goes on to state that the Commissioner may make examinations at five-year intervals, at which times the limit may be reduced below 5% if he feels such action is warranted by the status of the unfunded cost of past and current service credits. Sub-section (ii) provides that, in addition to the 5% mentioned above, any excess will be allowed which is necessary to fund the remaining cost of the past and current service credits distributed as a level amount or as a level percentage of compensation over the remaining future service of each employee. However, if the remaining unfunded cost with respect to any three individuals is more than 50% of such remaining unfunded cost, special treatment is provided. Under sub-section (iii), which is in lieu of (i) and (ii), the ceiling is the normal cost of the plan, plus an amount which is not in excess of 10% of the cost of completely funding the past service benefits. Sub-section (iii) does not appear to be a limitation on sub-sections (i) and (ii) (*Saalfield Publishing Co.*, 11 TC 756, A.) although Regulations Section 23(p)-6 is to the contrary.

Deductions under 23(p) are generally allowable only on a cash basis, except that taxpayers on an accrual basis are deemed to have made a payment on the last day of the year if the contribution for that year is paid within sixty days after the close of the taxable year. Contributions by cash basis taxpayers and contributions pursuant to plans which do not qualify under Section 165 may be taken only in the year paid.

Taxability of Benefits

The ultimate purpose of pension and profit-sharing plans is to provide benefits for employees and officers. A member of an approved plan pays no tax in respect of the employer's contributions until he receives the benefits therefrom. This principle applies even where a paid-up deferred annuity is given to him on separation from employment prior to retirement age. Where there is a life insurance element, the cost of coverage may be reportable as taxable income by the employee in the year of payment to the insurer by the employer or the trust.

Retirement benefits under qualified pension and profit-sharing plans are, in general, treated by the recipient, for tax purposes, as annuities. For contributory plans, only 3% of the total of the employee's contributions must be included in taxable income until the amount excluded equals his contributions; thereafter, the entire amount received is taxable. If the plan is non-contributory, the pension is taxable as received. Likewise, distributions by profit-sharing trusts are taxable as received. On termination of employment, if the employer's contributions to a

trust are distributed in a single year, the recipient is entitled to treat the distribution as long-term capital gain. This treatment does not apply to the receipt of an annuity contract and the Commissioner maintains that it does not extend to non-trusteed plans. Where such distribution includes securities of the employer, unrealized appreciation is not taxed until the distributee disposes of the shares. In the case of a deceased pensioner, the amounts received by his beneficiaries in the form of an annuity are taxable as ordinary income. However, under Section 303 of the 1951 Revenue Act, a contingent annuitant may exclude from income the value of the annuity includible in the estate of the deceased. After this cost basis has been recovered, the balance is taxable.

Profit-Sharing Plans

For company managements which look upon pension plans as a form of Russian roulette, the profit-sharing plan is an attractive alternative. It is adaptable to the needs of most companies and avoids undertaking a fixed commitment which may prove beyond the company's means in a business slump. A profit-sharing plan may be used as a substitute for a pension plan, may be combined with a pension plan or used as a supplement thereto. In *E. R. Wagner Mfg. Co.* (18 TC, #76), the employer was permitted by the Court to reduce its profit-sharing percentage in a year of comparatively low profits. To the extent permitted by wage and salary stabilization restrictions, profit-sharing trusts may be used as deferred compensation plans. Thus, the profits may be accumulated for a given period of years and then distributed to the beneficiaries together with the income earned by the trust. Such plans are flexible enough to accomplish such diverse objectives as: a) provide for retirement annuities; b) invest in insurance on the lives of stockholders, the proceeds of which may be used to meet the purchase price of stock from a decedent's estate; c) acquire control of a corporation on behalf of employees, etc.

The use of a profit-sharing plan in lieu of a pension plan (or no retirement plan at all) is deserving of careful study. Under this approach, the employer's contributions from profits are accumulated tax free in a qualified trust. An account is maintained by the trustee for each beneficiary reflecting his share in both the employer's contributions and the earnings of the trust. The first $3,600 of compensation of employees may be eliminated in arriving at the shares in the employer's contributions; however, the plan must then be integrated with social security benefits (*Mim. 6641*). Reallocations of forfeited credits arising from separations from employment may increase the shares of those who remain. At retirement, the trustees will buy an annuity with the employee's share of the trust fund. This may prove to be not as large an annuity as might have been obtained through a pension plan, but from the employer's standpoint the fund has been accumulated under most favorable circumstances because the contributions were only required in profitable years. It is important to note that if the benefits can be predetermined from the profit-sharing agreement, the plan will be considered to be, in effect, a pension plan; this might result in materially lower deductions in some years.

In debating the wisdom of adopting a profit-sharing plan, a characteristic which should not be discounted is that profit-sharing plans tend to create comparatively more incentive among those benefited than pension plans. Another advantage is that considerable flexibility is permitted in deriving a formula for determining the amount of the contributions to the trust. The formula may be based on a special definition of net profit, it may allow dividend requirements as a cost, or may be based on a graduated scale of percentages. Each year's contribution is lim-

ited to 15% of the compensation paid to the employees covered. The overall limitation where both pension and profit-sharing plans are in operation is 25% of compensation. Section 23(p) contains three provisions relating to profit-sharing plans which permit carryovers of deductions to succeeding years: 1) such part of a year's contribution which exceeds 15% of the compensation of covered employees; 2) the so-called "credit carryover", which may arise from a contribution of less than 15% of compensation; and 3) where both a pension and a profit-sharing plan covering some of the same employees are in effect, contributions in excess of 25% of compensation may be brought forward. For both (1) and (2) the total deduction in any year, including carryovers, may not exceed 15% of compensation for that year. Under (3) the aggregate of contributions and carryovers may not be greater than 30%. Although (3) may seem more liberal than (1) or (2) it should be understood that the total of contributions under concurrent pension and profit-sharing plans which do not cover the same personnel is not subject to the 25% limitation. The carryover privileges should be taken into account in drafting the plan so that the maximum tax advantages may be derived.

Section 165-1 of the Regulations states that a profit-sharing plan must be permanent and have a definite, predetermined formula for apportioning the profits to be shared. In the famous *Lincoln Electric Co. Trust* case (190 F. 2nd 326) a discretionary lump sum contribution of $1,000,000 was made out of profits to a trust in one year pursuant to a plan which did not contemplate any contributions in later years. The Sixth Circuit held, in reversing the Tax Court, that the Commissioner's regulation was invalid insofar as it required a permanent program and a definite formula for contributions. The Court pointed out that the plan provided a definite method of distribution to participants, that the contribution was irrevocable, and that there was no discrimination in favor of officers, stockholders, etc. As the Code exacts no other requirements, the Regulation was deemed to impose an unwarranted restraint. The Tax Court followed the *Lincoln Electric* case in *Produce Reporter Co.* (18 TC 69), although it expressly reserved any opinion about the validity of the Regulation.

Profit-sharing plans can become quite complicated in the allocation of shares among beneficiaries. It is usually advisable to make provision for an annual adjustment of interests at a time prior to the payment by the company of a year's contribution. Unless some such precaution is taken, the interest of some of the older beneficiaries may become diluted and an unwitting injustice will have been done.

Stock Bonus Plans

A stock bonus plan is one established to provide benefits similar to a profit-sharing plan. However, the contributions of the employer need not be based upon profits. The main point of distinction from a profit-sharing plan is that the benefits are payable in the stock of the employer. Stock bonus plans are not very popular at the present time, but, given the proper background and circumstances, such a plan may prove superior to a pension or profit-sharing plan, or may be used as a supplement to either or both.

Tax Examination and Follow-Up Controls

By Mamie Joan Feingold, C.P.A.

This paper makes some practical suggestions with respect to maintaining effective control over tax examinations in progress as well as over the necessary subsequent follow-up procedures.

The handling of a tax examination is not a simple matter from the viewpoint of the control mechanics. With the advent of sample audits and more frequent examinations, accountants are now burdened more than ever with the follow-up problems which ensue.

Many a week, or even month, elapses from the date of the first examination to the day the client sends the official report to your office for checking. In order to have a control of the examinations in process and a check on the necessary follow-up procedures, a definite record should be maintained. The form and operation of this record will be discussed in this article.

Follow-up Steps That May Be Required

A tax examination may create a number of follow-up situations. If these are listed and checked-off, the follow-up will be complete and timely. If left to memory, or if otherwise dealt with in an unorganized manner, some important action may be omitted.

The following are examples of steps that may be necessary after the completion of an income tax examination:

1. Submission of adjusting entries to client.
2. Refund claim prepared for prior year.
3. Refund claim for later unexamined year. (Where the filing of a claim for a subsequent year is to be postponed, a tickler record should be prepared to ensure action before the expiration date.)
4. Where adjustments affect subsequent unexamined years, as in the case of prior depreciation rate changes, these tax returns should be so earmarked.
5. Check the official report and final tax bill or refund memorandum.
6. Interest charges or credits should be checked. In this connection, it is necessary to have on the record the date of the signature on the waiver or the date the refund claim was filed.
7. Notify the New York State Tax Department of Federal changes.
8. Check on payments of tax that may be due to or from the tax department.
9. Where a waiver of the statute of limitations has been filed, it may be important to check on the receipt of the Commissioner's signed copy.
10. If appeals and litigation are involved, certain terminal dates must be watched.

    For instance, for a Federal income tax deficiency there may be the following:

Mamie Joan Feingold, C.P.A., is a graduate of Pace College and a member of our Society since 1948.

In addition to practice in the field of public accounting, Miss Feingold has had broad tax experience as an agent with the Internal Revenue Bureau, and as supervisor-accountant on utility audits and confidential secretary to the Director of the Bureau of Excise Taxes, New York City.

TAX EXAMINATION CONTROL FORM

Client *Andrews Corp.* Tax *Federal Income* Period *1/1/49-12/31/49*

EXAMINATION DATA

Representative *J. Burns*

Examiner:
- Name *Robert Brown*
- District Office *341—9th Ave., N.Y.C.*
- Telephone *LA 4-9400, Ext. 460*
- Dates *12/21/51, 2/10/52*

	Adjustments Proposed	Adjustments Agreed
Additional Income:		
Deprec. Machy. 5 to 10 yrs.	3,000.00	3,000.00
Repairs—Capitalized at 5 yrs.	7,000.00	5,000.00
Bad Debts to year 1946	5,000.00	3,000.00
Total	15,000.00	11,000.00
Additional Deductions:		
Amort. Lease Improve., 20%	1,400.00	1,000.00
N. Y. State Franchise Tax	748.00	550.00
Total	2,148.00	1,550.00
Net Adjustments	12,852.00	9,450.00
Net Income Reported	40,000.00	40,000.00
Adjusted Net Income	52,852.00	49,450.00
Tax Liability	20,083.76	18,708.50
Tax Paid	13,700.00	13,700.00
Additional Tax	6,383.76	5,008.50
Interest (Estimated) *12%*	766.05	601.02
Total	7,149.81	5,609.52

Remarks
(attach memos re conferences)

FOLLOW-UP DATA

Forms Signed: *#870, 2/15/52*

Check:
- Report *5/4/52 J. Burns*
- Tax Bill & Interest *6/25/52 M. Kane*
- Paid by Client *6/28/52 M. Kane*

Adjusting Entries* *5/4/52 J. Burns*

Prior Year Claims:
- 1—Filed at Once *5/4/52 J. Burns*
  or *1946—Bad Debt (IRC, sec. 322 (b)(5)).*
- 2—Follow-up Memo*

Future Year Adjustments for Returns Filed:
- 1—Amended Return
  or
- 2—Refund Claims
  or
- 3—Follow-up Memo* *5/4/52 J. Burns*
  1950—revised deprec. & amort. schedules
  1950—revised excess pfts. tax credit

For Later Years:
(follow-up memos, schedules, etc.) *5/4/52 J. Burns*
1951—revised deprec. & amort. schedules
1951—revised excess pfts. tax credit

N. Y. Tax Dept. Advised:
- 1—By Letter
  or
- 2—Follow-up Memo *5/4/52 J. Burns*

Time Spent:

12/21/51	*J. Burns*	*6 hrs.*
2/10/52	*J. Burns*	*4 hrs.*
5/ 4/52	*J. Burns*	*4 hrs.*
6/25/52	*M. Kane*	*½ hr.*

Billing to Client:
* *F. Sharp 6/30/52* Bill *#306*

* Prepare in triplicate.

30 day letter—this is a copy of the examiner's report and allows 30 days within which to file protest with the Director of Internal Revenue for the district.

90 day letter—this is the formal deficiency notice and allows 90 days within which to petition the Tax Court for redetermination of the deficiency.

Time requirements are strictly adhered to, and the final dates for action should be recorded sufficiently in advance to provide adequate time to prepare the necessary data.

11. Excess profits credits for other years may be affected.

Refund claims filed also require follow-up control. They should be recorded in a tickler to ensure further action by the accountant in the event that the tax office may not process the claim.

It should be obvious from the above listing that the matter of control should not be dealt with casually.

It is suggested that with respect to these problems a great deal of relief may be obtained, and oversights reduced to a minimum, by the use of a definite record and organized procedures. One basic form is submitted to record the historical details of the examination and its outcome, as well as to provide a check list for the follow-up procedures made necessary by reason of the adjustments. In addition, interoffice memos serve as supplementary follow-up reminders.

An illustrative form of the examination record, pertaining to a Federal corporation income tax audit, is submitted on page 756. It provides for the recording of the basic data which should be maintained as part of the tax file. Obviously, it can be revised to meet the needs of the individual practitioner. The follow-up section is also basic, but may be revised to suit the requirements of the individual office.

Attention is called to the record of proposed and final adjustments of taxable income on the examination record form. It may be useful for client-relation purposes and in determining the charge, if any, to be made for the services rendered. Moreover, in the absence of any other form of billing control, the examination record may also serve that purpose.

It should be observed that the form lends itself to use in the case of various types of taxes. Accountants may find it helpful for other federal, state and local tax examinations, using attachments for additional data where necessary.

How the Form Can Be Used

When the first appointment is made, the pertinent data (client's name, period to be audited, examiner's name, district office, telephone) are immediately recorded on the form and given to the tax department or other designated person for scheduling and assignment. It is then placed in an "In Process" file, either alphabetically or chronologically. If the form is taken to the examination, the record of the proposed adjustments, as well as those agreed to, may be made at that time. By this procedure, the record will always be currently maintained.

After the examination has been completed, the form should be kept alphabetically in a file called "Awaiting Reports". On receipt of each report, the examination record is attached to it and referred to the proper person for assignment or verification. In many cases, it would be most practical to refer the report to the person who had attended the examination or conference. His name is readily available on the form. He might also find it feasible to prepare the necessary journal entries in triplicate for distribution as follows:

Original—mailed to client for entry on books.

Duplicate—current file for attention of accountant in charge of audit.

Triplicate—tax file for year audited.

In the illustration (page 756), a bad debt deduction of $3,000 was disallowed

for 1949 on the grounds that it had become uncollectible in 1946. Therefore, a claim for refund is to be filed for the year 1946, under IRC, sec. 322(b)(5). Mr. Burns checked the report and prepared the claim at the same time. Otherwise, he would have prepared a follow-up memo for the claim in triplicate, as follows:

Original—tax department.
Duplicate—current file.
Triplicate—1946 tax file.

The adjustment for capital expenditures on the 1949 return entitles the taxpayer to an increased deduction for depreciation and amortization in subsequent years. In the example, the taxpayer is entitled to a refund for 1950, for which year a return had been filed. This claim could be prepared at the time the report is being checked. In this illustration, it was decided to hold the claim in abeyance on the possibility that 1950 would be examined, and that the additional deductions would then be allowed. Mr. Burns therefore prepared an appropriate follow-up memo in triplicate for distribution as follows:

Original—tax department.
Duplicate—current file.
Triplicate—1950 tax file.

In the illustration, the 1951 return had not as yet been prepared when the Revenue Agent's report for 1949 was received. (Andrews Corp. had received an extension of 90 days within which to file its return.) Therefore, a memorandum containing revised depreciation and amortization schedules was prepared by Mr. Burns for the 1951 tax file. If this procedure is maintained throughout the year, it would save precious time during the tax period.

The New York State Tax Law requires that the State Tax Department be advised of any changes resulting from the Internal Revenue Bureau audits of income tax returns. This notification may be by special notice within 90 days after receipt of the determination, or on the next return filed. In the illustration, it was decided to give such notice with the next return. Mr. Burns prepared a short memorandum to serve as a cross-check when the New York State return is being prepared. This memo should be placed in a tickler or other follow-up record, according to due date of the State return.

The form also has provision for remarks and for a record of conferences held. In some instances, it may be advisable to attach additional sheets.

For the smaller office, it might be more practical to use diaries to record the necessary follow-up procedure instead of using memoranda. Diaries may be obtained for three or four years in advance, and the follow-up items may be recorded therein as to terminal date.

The time consumed in handling the examination will have been entered on the form as the matter progressed. After the follow-up procedure has been completed, the record may be given to the tax department or principal to determine the amount to be billed for the services. The information on the completed form will contain the time consumed and the staff names, the nature of the matter handled, and should be of assistance in this connection. Where special billing is not made, the pertinent data could be posted to the client's time sheet, and considered in fixing the year-end fee, if that is the accountant's practice.

When the form has been completed and the follow-up procedure carried out, it may still be of service to your office in connection with the preparation of returns and for examination of subsequent and related returns. It is therefore recommended that these records be placed in a "Tax Examination-Closed" file for future reference.

Careful consideration should be given to the type of paper stock to be used for the form. It is recommended that the type of stock used for punched card forms be utilized to withstand frequent handling and make for a lasting record.

May the Gain on the Liquidation of a Collapsible Corporation Escape Taxation?

By JULIAN S. H. WEINER, C.P.A.

This article discusses the IRC sections dealing with collapsible corporations and one-month liquidations. It is the author's opinion that the latter section offers a temporary haven for the tax-free liquidation of collapsible corporations.

PRIOR to the Revenue Act of 1950, the corporate fiction represented a convenient method for the conversion of ordinary income into a capital gain via either corporate liquidation or the sale of stock therein. The aforementioned revenue act, however, has barred this device for collapsible corporations engaged in the manufacture, construction, or production of property. This new concept of collapsible corporations was directed particularly against closely held corporations. Undoubtedly, therefore, the barrier erected by the said provision could have been hurdled without great difficulty by the formation of a partnership, rather than a corporation, to conduct the specific venture. The capital gain objective would be achieved by the sale of a partnership interest prior to the realization of ordinary income. The foregoing solution, however, will not dissipate the dilemma confronting individuals who have already availed themselves of the corporate entity. The question proposed by this discussion, therefore, is whether any remedy exists for such individuals who are now stockholders in collapsible corporations. Since the cure, if any, must be prescribed from the ingredients contained in the statute, it would be expedient, at this point, to examine the salient features of the tax law and proposed regulations on the subject.

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Mr. Weiner was graduated from The City College (N. Y.) School of Business and Civic Administration with the degree of B.B.A. and from St. John's University with the degree of LL.B. He is a member of Beta Gamma Sigma.

Mr. Weiner has written previously for the *New York Certified Public Accountant* and the *Journal of Accountancy*.

Controlling Provisions of Internal Revenue Code and Proposed Regulations

I. R. C. Sec. 117(m)(2) defines a collapsible corporation as,

> "a corporation formed or availed of principally for the manufacture, construction, or production of property, etc. . . ., or for the holding of stock in a corporation so formed or availed of, with a view to—
>
> (i) the sale or exchange of stock by its shareholders, prior to the realization by the corporation manufacturing, constructing, producing or purchasing the property of a substantial part of the net income to be derived from such property . . ."

Under Sec. 117(m)(1), the gain from the sale of stock in, or the liquidation of, a collapsible corporation, as defined above, would be taxed as ordinary income.

An important avenue of escape was blocked by Sec. 117(m)(2)(B) which states that,

> "For the purposes of subparagraph (A), a corporation shall be deemed to have manufactured, constructed, produced or purchased property, if—
>
> (i) it engaged in the manufacture, construction, or production of such property *to any extent . . .*" (emphasis supplied).

Accordingly, the liquidation of a covered corporation, or sale of stock therein, prior to the completion of the property would still result in ordinary income.

Section 117(m)(3)(C), however, offers some measure of relief, albeit limited, by providing that,

> "this section shall not apply to gain realized after the expiration of three years following the completion of such manufacture, construction, production or purchase."

In effect, therefore, any disposition of corporate property or stock held therein would have to be postponed three years in order to assure a realization of a capital gain rather than ordinary income.

Sec. 117(m) does provide other means of avoiding the tax consequences of a collapsible corporation. In the main, however, such provisions would not be available to the average taxpayer. Moreover, the Commissioner, by his recently proposed regulations concerning Sec. 117(m), has strengthened the tenor of the restrictions contained in the law. But, in spite of the Commissioner's obvious efforts to anticipate and intercept any course of avoidance of the said section, there still appears to be, temporarily, an open lane. In this connection, Section 29.117-11(c) of the proposed regulations, interpreting I. R. C. Sec. 117(m)(1), states that Sec. 117(m),

> "shall apply *only to the extent* that *the recognized gain* of a shareholder upon his stock in a collapsible corporation *would be considered, but for the provisions of this section, as gain from the sale or exchange of a capital asset held for more than six months.*" (Emphasis supplied.)

Accordingly, Sec. 117(m) is intended to cover only those transactions which would normally have been taxed as a long-term capital gain, *"but for the provisions of this section"*. Hence, it would seem that if an otherwise collapsible corporation could be liquidated tax-free under some other section of the law, Sec. 117(m) could not be invoked. As explained hereafter, nontaxable liquidations can be effected under a provision of the Code expiring December 31, 1952.

Remedy Offered by One-Month Liquidations

Sec. 112(b)(7) establishes certain conditions under which a domestic corporation may be liquidated tax-free. In order to qualify, the dissolution must be accomplished pursuant to a plan of liquidation adopted after December 31, 1950. In addition, the redemption of all the corporation's stock and the transfer of all its property to the stockholders must take place within one calendar month in 1952.

If the liquidation satisfies these requirements, all stockholders who qualify (restrictions are not material with respect to individual stockholders as distinguished from corporate stockholders) may elect to have the gain from the liquidation treated as follows:

1—The pro-rata share of the corporate earnings and profits accumulated after February 28, 1913 to be taxed as a dividend.

2—The portion of the over-all gain in excess of the ratable share of such earnings and profits to be taxed as a capital gain to the extent that the value of the cash, stock or securities (acquired after August 15, 1950) received by the stockholder exceeds the said ratable share.

3—The balance of the gain to be taxed when the property is disposed of.

Generally, the surplus, cash, or securities possessed by a true collapsible corporation is negligible. Therefore, the tax consequences of its liquidation should be governed, primarily, by item 3 above. That is, the recognition of the gain would be deferred until the ultimate disposition of the property. Hence, to the extent the liquidation would not be taxed as a long-term capital gain, it should avoid the impact of Sec. 117(m) which is applicable only where a long-term capital gain would have resulted but for the provisions of this section.

In passing, it should be noted that property liquidated without recognition of gain under Sec. 112(b)(7) assumes the basis of the stock held by the taxpayer. If this property is a capital asset, as would be the case, generally, its eventual disposition would be taxed as a capital gain. Otherwise, the same tax treatment could be achieved by the transfer of such property to a partnership in contemplation of subsequent sales of partnership interests, which, as indicated previously, are taxed as capital gains.

Conflict of Laws

The foregoing discussion is also intended to highlight a possible inconsistency between Sec. 112(b)(7) and Sec. 117(m).

Sec. 112(b)(7) appears to have been designed, chiefly, as a means of rescuing corporations from the deluge of the excess profits tax and increased corporate income taxes. However, as stated before, the accumulated surplus of a corporation liquidating under this section would be treated as an ordinary dividend. Hence, it is only natural that only those corporations, whose gain would be measured by an appreciation in asset valuations rather than by actual earnings, would rely on the said section. In this connection, it is noteworthy that this feature of increased property values is also characteristic of the collapsible corporation. It is not inconceivable, therefore, that corporations which have liquidated under Sec. 112(b)(7) would also qualify as a collapsible corporation. Accordingly, the Commissioner may try to convert capital gains stemming from such liquidations into ordinary income. This line of attack would be based on the ground that Sec. 117(m) applies to liquidations of collapsible corporations which, but for the provisions of this section, would have been taxed as a capital gain. It is also this writer's opinion that Sec. 117(m) is broad enough to cover stockholders qualifying under Sec. 112(b)(7).

Conclusion

Sec. 112(b)(7), therefore, appears to offer a temporary haven for the liquidation of collapsible corporations, to the extent that no gain would be reported under the said section. Conversely, Sec. 117(m) may become a stumbling block for capital gains reported under the former statute with respect to individuals who would also be considered as stockholders of a liquidated collapsible corporation. Consequently, the impact of Sec. 117(m) upon Section 112(b)(7) will probably be felt long after the expiration date of the latter provision.

Federal Tax Commentaries

By Edward T. Roehner, C.P.A.

Some critical thinking on current tax problems.

Deducting Excess Profits Taxes Both Paid and Accrued in Determining Net Operating Loss

Section 122(d)(6) allowed the World War II excess profits tax "paid or accrued" as a deduction in computing the net operating loss. The taxpayer, who used the accrual method, argued that it was entitled to deduct in 1944 the amount paid in 1944 on the excess profits tax for the previous year and also its excess profits tax accrued for 1944, which was paid in 1945. The taxpayer advanced in its support the *Clarion Oil Co.* case, 148 F. 2d 671 (1945), in which the Court of Appeals for the District of Columbia held that in determining the undistributed Subchapter A net income of a personal holding company a cash basis taxpayer could deduct accrued federal income taxes. The Tax Court said in the instant case that the *Clarion Oil Co.* case rested upon the peculiar nature of the problem of determining the undistributed personal holding company income and should not be extended to the present controversy.

The Tax Court, in an opinion by Judge Tietjens, which was reviewed by the full bench without dissent, continued that "despite taxpayer's belief that the present case is one of first impression the Commissioner cites and relies on *Estate of Julius I. Byrne, et al.*, 16 T.C. 1234 (May, 1951) . . . This case seems to us squarely to confirm the Commissioner's contentions here, and we hold that in making the computations called for under section 122(d)(6) the phrase 'paid or accrued' should be construed according to the method of accounting upon the basis of which taxpayer's net income is computed." (*Lewyt Corp.*, 18 T. C. No. 151, September 30, 1952).

We do not find the *Byrne* case at all in point, let alone squarely in point. The taxpayer in that case had argued solely that it was on the cash basis and therefore should deduct excess profits taxes in the year paid. The Tax Court there said that the taxpayer had not shown that the admittedly hybrid system it used was more like the cash basis than like the accrual basis, and the court therefore decided that the taxpayer was on the accrual basis. The sole question in the *Byrne* case was whether the taxpayer was on the cash basis or the accrual basis, for the taxpayer did not contend that it could deduct the taxes in the year paid if it was on the accrual basis.

In our opinion, the taxpayer in the instant case was therefore correct in saying that the case was one of first impression, and the Tax Court was in error in saying that the *Byrne* decision decided the issue.

Edward T. Roehner, C.P.A. and attorney, is a member of our Society, of the American Institute of Accountants, and of the Association of the Bar of the City of New York. He was formerly Associate Editor of the New York Law Journal and later Technical Head of the Federal Tax Department of Research Institute of America. Mr. Roehner is now engaged in the practice of tax law in New York City.

Renunciation of Intestate Share as a Taxable Gift

On October 13, 1952, the Supreme Court denied certiorari in *Ianthe B. Hardenbergh, et al.* v. *Commissioner*. George S. Hardenbergh had died in-

testate in 1944. His heirs, who were his wife, their daughter, and a son by a former marriage, inherited about $250,000 in equal shares. The wife, Ianthe, and the daughter were both rich by inheritance from the wife's family. Before he died, the decedent told his wife and his daughter that he would like to leave practically his entire estate to his son, in order to equalize somewhat the financial position of his children. They consented. A will was drafted and brought to his home by the attorney. The decedent, who was seriously ill, died without executing it. To carry out the decedent's wishes, the wife and the daughter filed renunciations of their shares in the estate, and the probate court entered a decree distributing the entire estate to the son.

The Commissioner determined that the renunciations by the wife and the daughter were taxable gifts, and he assessed about $24,000 in gift taxes.

The Eighth Circuit, affirming the Tax Court, in 198 F. 2d 63, June, 1952, stated that it is the rule generally that when a decedent dies intestate, title to his property vests immediately in his heirs by force of law, and that the passage of title is beyond the power of the heirs to prevent. The court agreed with the Commissioner that the renunciations were therefore taxable transfers by gift. It is not as if they were beneficiaries under a will, the court said, who may renounce, their renunciation dating back to the date of death of the decedent.

The taxpayers did not controvert the Commissioner's position, but sought to avoid it by arguing that the transfers had been by decree of the probate court. This argument was one that was bound to make the court feel that the taxpayers had no case, for, as the Eighth Circuit pointed out, the probate decree itself had said that it was based on the filed renunciations by the taxpayers.

When we examined the cases cited by the Eighth Circuit in support of its statement that an heir may not renounce, we found that they were cases in which the heirs had attempted to defeat the rights of creditors by renouncing. However, even beneficiaries under a will, it has been held, may not renounce if the renunciation will defeat the rights of creditors. (See, *e.g.*, the *Kalt* case, decided by the Supreme Court of California in 1940, cited by the Tax Court on another point in *Estate of William L. Maxwell,* 17 T. C. No. 196, March, 1952, in which the Tax Court followed its decision in the *Hardenbergh case.*) The cases cited by the Eighth Circuit were therefore, in our opinion, not in point.

Amount Collected by One Joint Venturer from the Other for Violation of Fiduciary Relationship—Is it Partnership Income?

A corporation and an individual were joint venturers for two months of 1933 on the sale of stock of a certain company. The corporation dealt secretly in other stock of that company in violation of its fiduciary relationship to the individual, who died in 1936, ignorant of the violation. In 1939 his executrix learned of the secret dealings and sued the corporation. She recovered judgment, and payment was made in 1944.

The Tax Court, in an opinion by Judge Hill, reviewed by the full bench, no dissents, held that the Commissioner was correct in maintaining that the recovery was to be reported in 1944. The taxpayer had argued that the amount should have been reported in 1933 as joint venture income. (*Adele Trounstine,* 18 T. C. No. 149, September 30, 1952.)

One published analysis thereof maintains that the Tax Court was incorrect, that the amount should have been reported in 1933 under section 182, which, the analysis said, clearly and flatly provides for the inclusion of a partner's distributive share of the partnership income in the year in which it is earned. It said that the Tax Court had not even mentioned the decisions

which have held that a partner's share of the partnership income is taxable to him as earned by the partnership. An appeal was advised.

We believe that the Tax Court was correct. The partnership never made this income; hence, the partnership could not report it. The suit by the executrix was for something entirely different from partnership income. It was for a share in the profits which the corporation had made by dealing in the stock it owned instead of in the stock in the joint venture, in violation of its fiduciary relationship to the decedent.

Deductibility of Split Fees

The New York Herald Tribune on September 26, 1952, reported that the American College of Surgeons was starting a concerted drive against fee splitting by surgeons, and that the Bureau of Internal Revenue would not permit surgeons to deduct split-fee payments in states where fee splitting was illegal. On the evil of fee splitting, the surgeons said that in large cities competition made surgeons easy prey to the fee splitting practice, and that a surgeon starting practice in a community in which fee splitting is rampant would starve if he refused to split fees.

I.T. 4096, in IRB No. 18, September 1, 1952, provides, among other things, that split fees will be disallowed if they frustrate a sharply defined State policy. The Bureau maintains that Section 6514(f) of the Education Law of the State of New York prohibits the payment of split fees, and it is therefore disallowing deductions by New York surgeons for split fees. The belief that the payment of a split fee is prohibited by this section has long been prevalent among surgeons. Some surgeons have not been including in gross income the amounts they paid out in split fees, reporting only the net fee retained by them. The Bureau is insisting that these surgeons include in gross income the amounts paid out in split fees during the past years, and is denying a deduction for the split fees paid out. In addition, the Bureau is assessing the fraud penalty.

We believe that, as to those surgeons who have reported the split fee payments in gross income and taken the payments as deductions, the courts will not uphold the Bureau. Section 6514(f) of the Education Law reads that the license of a physician may be suspended or annulled if he has "requested, received or participated in" the splitting of a fee. The entire section is instinct with the prohibition of requesting or receiving the split fee, as though the draftsman was aware that the evil lay in the demand for the split fee. Under ordinary rules of statutory construction, the words "participated in" are to be interpreted in the light of the preceding language, which means that the prohibition is limited to a doctor who has requested, received, or participated with other doctors in the division of an amount received as a split fee. If the section had been intended to apply also to doctors who make the payments, it would have been easy to add the words "offered or paid" after "requested, received."

New York State Tax Forum

Conducted by Benjamin Harrow, C.P.A.

Tax Exempt Interest

Under Section 22 (b)(4) of the I. R. C., interest on obligations of a state or a political subdivision of a state is excluded from gross income and so exempt from the federal income tax. This provision has been put in the law as a recognition of the fact that a state is a sovereign power and as such should not be taxed by the federal sovereignty. Our federal constitution does not contain any express provision prohibiting the federal government from taxing state instrumentalities. However, in holding unconstitutional the income tax provisions of the Tariff Act of 1894,[1] the Supreme Court cited as one of the reasons for the invalidity of the income tax the fact that the law taxed interest on obligations of a state.

Under the provisions of the State income tax law, Section 359, New York exempts from tax any interest on federal instrumentalities. Even without such express provisions New York would be without power to tax the federal sovereignty unless the federal government gave its consent. Under the New York law, interest on obligations of this state or its political subdivisions is also exempt from the New York income tax. If New York chose to tax such interest it undoubtedly could do so, just as interest on federal obligations is subject to the Federal income tax. It should be noted that under the New York law interest on obligations of other states is taxable. This creates an anomalous situation wherein a sovereign state presumably has a greater power than the federal sovereignty which, under the *Pollack* v. *Farmers Loan and Trust Co.* rule, could not tax the instrumentalities of any state.

There is an obvious tax advantage in the ownership of tax-exempt securities which increases as an individual's tax bracket increases. If all the income of a New York resident were derived from New York State Bonds, such a taxpayer would pay neither a federal income tax nor a state income tax.

The city of Florence, Alabama, recently issued 5% First Mortgage Development Revenue Bonds. The money is to be used for the purchase of land, the erection of a manufacturing plant and purchase of equipment for a tile manufacturer. The corporation operating the plant will have a 25 year lease from the city. The rental will be equal to the amount necessary to pay off the bonds plus interest. The bonds will mature serially from 1954 to 1977, and both principal and interest are payable only from the rentals. Bondholders have the privilege of converting the

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Mr. Harrow has been a member of the American Institute of Accountants since 1922 and is a member of the New York Bar. He is now serving as one of the Vice-Presidents of the Society and is also on the Society's Committee on Federal Taxation, and is past Chairman of its Committee on State Taxation. He is also a member of the Institute's Committee on Federal Taxation and its Council.

Mr. Harrow is engaged in practice as a certified public accountant and attorney in his own office in New York City.

[1] *Pollack* v. *Farmers Loan & Trust Co.*, 158 U.S. 601 (1895).

bonds into stock of the corporation. The prospectus states, that in the opinion of counsel, interest on the bonds is exempt from federal income tax. If that proves to be correct the city will benefit by the increased industry and employment. The corporation on the other hand has a plant built for it presumably at a favorable rental. In our opinion there may be some doubt as to the exemption of the interest from tax since the bonds are being issued for a purpose which is not essentially governmental.

Definition of Capital Assets

Under the Internal Revenue Code all assets are capital assets with certain enumerated exceptions. Among the exceptions are depreciable assets and real estate used in a trade or business. Under such a definition a gain resulting from the sale of real estate or depreciable assets used in a trade or business would be taxed as ordinary gain. However, under Section 117 (j) such a gain may be treated as a capital gain, whereas a loss may be considered as an ordinary loss.

The State Tax Commission is presently considering suggestions for changes in the income tax law and it would be desirable to conform the state law to the federal law in this respect. From an accounting standpoint, real estate and depreciable assets are capital assets and it would be more equitable to treat gains as capital gains. While a case could be made for treating losses as capital losses, since such assets are used in a trade or business, it would appear to be more equitable to continue to allow the loss to be treated as an ordinary loss. As the state law now stands, a loss is allowed as an ordinary loss but the gain is treated as an ordinary gain taxable at the higher rates.

Treatment of a Net Capital Loss

Taxable net income is not always the same as economic income or true net income. The taxation of capital gains and the extent to which capital losses are allowed as deductions highlights inequities that sometime creep into the determination of taxable net income. Where a capital net loss exceeds ordinary net income or an ordinary net loss exceeds a net capital gain under the state income tax law a taxpayer may be subject to a tax, even though the true net income for the taxable year shows a net loss.

To mitigate the harsh tax effects inherent in such a situation it is suggested that a net capital loss be allowed in whole or in part as a deduction against ordinary net income. Under the Internal Revenue Code a net capital loss is allowed as a deduction to the extent of $1,000.00. A similar provision should be provided for under the state law. Since capital gains are taxed at one-half the normal rates, perhaps a 50% adjustment should be considered in allowing a deduction of a net capital loss against ordinary income.

Where an ordinary net loss exceeds a net capital gain obviously it would be equitable to allow a deduction of the net loss against the net capital gain.

Deduction for Contributions

Under the Internal Revenue Code, the limitation of the deduction for contributions is now 20% of adjusted gross income. Since net capital gains are included in adjusted gross income, the deduction for contributions can be greater under the Internal Revenue Code than under the state income tax law, since capital gains are not included in the determination of the deduction for contributions under state law. It is therefore suggested that the Tax Commission consider two changes in the provisions with respect to the deduction for contributions. First, the maximum deduction should be increased to 20% of ordinary net income to conform with the federal law. Secondly, if contributions exceed 20% of ordinary income, the excess should be allowed as a deduction from net capital gains.

Optional Deduction

This deduction under the state income tax law was intended to simplify the problem of personal deductions just as the standard deduction treated the problem under the Internal Revenue Code. Unfortunately, the definition of optional deduction has distorted its purpose. Under the state law the optional deduction is limited in its application because it must be used in lieu of all deductions, including ordinary and necessary expenses of a business. It is strongly urged that the Tax Commission consider a change in the definition of the optional deduction to conform with the standard deduction under the Internal Revenue Code. Under state law an individual deriving income from a partnership reports his net distributive share of partnership income and in addition may take the optional deduction. However, if he is a single proprietor he may not deduct his business expenses plus the optional deduction. The optional deduction was not intended to work that way.

Dissolution Under Section 354 (9)-a

The 1952 legislature introduced a new provision in the law, Section 354 (9)-a, comparable to Section 112 (b)(7) under the Internal Revenue Code[2]. This is a relief measure that postpones the recognition of a gain on a corporate liquidation where assets of a corporation distributed to stockholders have appreciated in value. The basis of the property received in liquidation is the stockholder's investment in the stock of the corporation. For Section 354 (9)-a to apply, the liquidation must take place in one calendar month during the year 1951 or 1952.

If a taxpayer subsequently disposes of assets received in a liquidation under Section 112 (b)(7), does he then have a capital gain or ordinary income? This was an issue in a recent case[3]. The taxpayer was a 50% stockholder in a corporation that was liquidated under Section 112 (b)(7). Among the assets of the corporation received by him were notes and mortgages. Collections on these assets resulted in a profit to the taxpayer of $3,400, which he reported as a long-term capital gain. The Commissioner considered the profit as ordinary income, arguing that the liquidation of the corporation was a closed transaction, the disposition of the assets received upon liquidation being a separate transaction resulting in ordinary income or capital gain depending upon the nature of the asset. The Tax Court[4] and the Circuit Court agreed with the Commissioner. Collections of notes and mortgages result in ordinary income. If the notes and mortgages had been sold in excess of its basis, the profit would be a capital gain.

This decision may be an indication of how the state will rule in a similar situation when it arises under Section 394 (9)-a.

Constructive Receipt

Both the federal and state income tax laws provide generally for reporting income either on a cash or accrual basis. On the cash basis income is taxable when it has actually been realized in the form of cash or its equivalent. To implement this concept the regulations (Federal Reg. 111, Section 29.42; State Reg. Art. 44) introduce the principle of constructive receipt. That means generally that income available to a cash basis taxpayer may be taxed to him even though it has not yet been received by him during the taxable year. Without such a provision a taxpayer could himself determine the year in which income is to be reported.

A recent case[5] is a typical illustration of how the doctrine of constructive receipt works. In this case two brothers

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[2] See New York State Tax Forum, June 1952, p. 369.
[3] *Oscnbach*, C.A. (4) July 24, 1952.
[4] 17 T.C. 797, November 19, 1951.
[5] *Cooney*, 18 T.C. (No. 111), August 20, 1952.

were the stockholders and directors of a corporation. In January, 1947, the directors authorized a bonus of 10% of the profits for 1947 to the brothers. In December, 1947, the directors authorized a payment of $10,000.00 to each brother during that month, the balance to be paid after the end of the year. At that time the corporation was assured of adequate profits to cover the bonus. The actual payment was not made until 1948.

The Commissioner held that the entire bonus was constructively received in 1947. The Tax Court held that only the $10,000.00 was taxable in 1947, since that amount was not subject to any restrictions. That was available to them in 1947 since they could have withdrawn the money at any time and there was sufficient cash in the bank to cover that amount. The balance of the bonus was taxable income in 1948.

There was another angle to the case. If a corporation is on the accrual basis a deduction for accrued expenses to a related creditor on a cash basis is not allowed unless the payment is made no later than 2½ months after the close of the taxable year. (Section 24 (c), I.R.C.). There is no similar provision in the state income tax law.

Unincorporated Business Tax—Nature of the Tax

This tax is imposed upon the net income of any unincorporated trade, business or occupation carried on within the state. Section 386 defining unincorporated business now[6] includes a business being liquidated. An individual is not deemed to be engaged in an unincorporated business for the purpose of this tax "solely by reason of the purchase and sale of property for his or its own account or that an owner, lessee or fiduciary shall be deemed solely engaged by reason of holding, leasing or managing real property or that an individual shall be deemed so engaged with respect to compensation for services rendered by him as an employee, or as an officer of a corporation, . . . unless such compensation constitutes receipts of a business regularly carried on by such individual."

Take the case of an individual who is in the real estate business. Assume that he transfers to a separate corporation each parcel of real estate that he purchases. Suppose he is an employee and officer of six separate corporations, each one owning a single parcel of real estate. The employee officer receives a salary from each corporation for managing the property of each corporation. Is the individual engaged in an unincorporated business? If one corporation owned all the properties the salary of the employee would clearly be exempt from the unincorporated tax. Does the multiplicity of corporations alter the relationship of the taxpayer from an employee to an independent contractor engaged in a business? We think not, unless it can be said that the taxpayer is in the business of being an employee. That "business" was intended to be exempt from the unincorporated business tax. Otherwise any taxpayer who happens to be an officer of more than one corporation might find himself subject to this tax. An individual may be employed by more than one employer. In the real estate business it is a common practice to incorporate separately each separate property acquired, principally for reasons of minimizing liability.

This situation is different from the real estate broker who acts as an independent contractor or a salesman who is employed by more than one employer, but who is free to procure and promote sales by his own methods and efforts. In border line cases the Tax Commission will look into such questions as whether the employee is performing services in an office maintained entirely by the employer or by himself, whether the employee is accountable to the employer both as to

[6] Ch. 703, Laws of 1952.

the method in which his affairs are carried on and the results obtained[7].

Bad Debt Deduction—Change to Reserve Method

Until the law was amended in 1939[8] the deduction for bad debts under the New York law was restricted to debts ascertained to be worthless and charged off during the taxable year. Beginning with the year 1939, the law permitted a deduction of "a reasonable addition to a reserve for bad debts." For the year 1939 a taxpayer changing from the actual charge-off method to the reserve method was required to follow the procedure outlined in Article 161-a of the Regulations. He was permitted to deduct actual bad debts ascertained to be worthless and charged off during the year 1939. In addition, he was permitted to charge off a reasonable addition to a reserve that should reasonably have been set up as of December 31, 1938. To determine that amount the regulation requires the computation of a reasonable reserve as of December 31, 1938, and a similar computation of a reasonable reserve as of December 31, 1939. The difference between the two represented the reasonable addition that was allowed as a deduction.

Deputy Commissioner Kassell, in an opinion[9] issued by him, states that this is the procedure that must be followed for any year where a taxpayer is permitted to change from the actual charge-off method of deducting bad debts to the reserve method. It should be noted that this procedure is not as favorable to the taxpayer as the one permitted under the federal law. In the change-over year under the Internal Revenue Code, the taxpayer may deduct the entire reserve set up at the end of the taxable year in addition to the actual bad debts charged off.

7 Article 5 of Official Questions and Answers.

8 Chapter 20, Laws of 1939.

9 October 7, 1952.

Accounting at the S. E. C.

Conducted by Louis H. Rappaport, C.P.A.

On October 30, 1952, the SEC announced a decision suspending the accounting firm of Haskins & Sells and one of its partners, Andrew Stewart, individually, from appearing or practicing before the Commission for a period of ten days beginning November 29, 1952. The findings and opinion of the SEC are contained in its Accounting Series Release No. 73, copies of which were not available at the date of this writing. On the day it announced its decision, however, the SEC issued a summary of this Accounting Series Release. The following is quoted from that summary; a statement by Haskins & Sells appears below.

> The basis for the decision was a finding by the Commission that the financial statements prepared and certified by the respondents and included in the registration statement filed in 1947 by Thomascolor, Incorporated, were defective. The registration statement in question was permitted to become effective only after extensive hearings and the filing of material amendments correcting the "highly misleading" financial statements and other material misrepresentations and omissions then found by the Commission.
>
> In the present proceedings, which were commenced in 1948 and conducted privately, the Commission found that "respondents' accounting treatment and disclosures were materially inadequate and the financial statements certified by them were materially misleading in important respects. Those deficiencies resulted directly from respondents' failure to follow generally accepted accounting and auditing principles and practices and professional standards, and rules, regulations and prior decisions of this Commission. Under the circumstances we find that respondents have engaged in improper professional conduct within the meaning of Rule II (e)" of the Commission's Rules of Practice.
>
> The deficiencies in question related primarily to a $2,014,941.03 item in the balance sheet captioned "Patents and Patent Applications" and representing all but $536,642.37 of the company's assets. Noting that the public was to be asked by Thomascolor to invest $10,000,000 in a "highly speculative venture" against a long history of attempts to develop and exploit inventions in color photography which had involved the expenditure of large sums of money without any evidence of commercial success, the Commission observed:
>
> "It was against this background that respondents prepared and certified balance sheets which grossly overstated intangible assets by the arbitrary use of the par and stated value of shares of stock issued to acquire the assets, including shares expected to be reacquired from promoters as a donation, and attributed to apparently potentially productive items material amounts which should have been shown as promotion services."
>
> This, the Commission said, reflected an "inexcusable" disregard of their professional obligations. Respondents, on the other hand, "steadfastly maintained that their presentation and procedures were reasonable and justified. They insist that they acted in good faith, that the situation presented was a unique one and if we find any error on their part it would reflect no more than a difference of judgment as to method of handling such situation, and that no willful or deliberate disregard of our rules or accepted accounting practice was involved. It is also stressed that Stewart enjoys an excellent reputation in his profession and has never had any prior question raised with respect to his accounting activities."
>
> The Commission stated that it accepted respondents' assertion that they acted in good faith "and accordingly do not find any willfulness in the sense referred to by them. However, in a disciplinary action under Rule II (e) we are not required to make such a finding. We are of the opinion that respondents' accounting work in connection with the Thomascolor registration statement was so deficient in the respects

Louis H. Rappaport, C.P.A., has been a member of the Society since 1933. He is a partner in the firm of Lybrand, Ross Bros. & Montgomery, C.P.A.'s.

set forth above, as a result of their failure to give this professional undertaking the degree of care and inquiry it demanded under the circumstances, that disciplinary action is required."

With respect to the action taken by the SEC, the firm of Haskins & Sells made the following statement:

The decision was the culmination of a proceeding brought by the Securities and Exchange Commission under Section II (e) of its Rules of Practice to determine whether our firm had been guilty of "unethical or improper professional conduct" in the certification in August 1947 of financial statements of Thomascolor, Incorporated, as originally filed.

The proceeding was initiated in May 1948. The case was argued in our behalf before the Commissioners by the late Hon. Robert P. Patterson on May 8, 1950. On October 30, 1952, the Commission handed down its Findings and Opinion.

In its Findings and Opinion the Commission accepts our assertion that we acted in good faith and accordingly does not find any willful or deliberate disregard of its rules or accepted accounting practice. Nevertheless the Commission has suspended our firm and one of our partners, Andrew Stewart, from appearing or practicing before the Commission for a period of ten days commencing November 29, 1952. Its punitive action is predicated upon its having reached a different judgment and conclusion than we did concerning the highly complicated and extremely difficult technical accounting questions involved.

This is the first instance in the history of the Commission that disciplinary action has been based on differences of judgment as to proper accounting treatment. All previous disciplinary orders of the Commission against accountants have involved a willful disregard of the Commission's rules or of accepted accounting principles and practices.

The only securities of the registrant sold to the public were 200 shares at $10 each. Sales of securities by predecessor companies took place long prior to the time when we were first retained to do any accounting work for any of these companies.

The issues involved accounting judgment as to the treatment of certain transactions relating to intangible assets and their presentation in the financial statements. In support of our position we called as witnesses three eminent certified public accountants whose testimony supported us unequivocally. Two of these experts are former presidents of the American Institute of Accountants, while the third is an outstanding member of the profession with a national reputation. No expert testimony was offered in rebuttal of these witnesses. Nevertheless, the Commission in its decision gave little if any weight to the testimony of these three independent experts, saying:

> "However, as we have previously stated, while the opinions of qualified expert accountants may be helpful, this Commission must in the last analysis weigh the value of expert testimony against its own judgment of what is sound accounting practice. We have given careful consideration to the testimony of the experts as well as to all the other evidence in arriving at our conclusions herein. We have not deemed it necessary to discuss their testimony since the views they expressed were substantially the same as those of the respondents."

It was only by thus brushing aside the testimony of these eminent experts, as well as our other evidence, that the Commission reached the conclusion that our accounting work was at fault. This presumably was the basis for the action taken.

The principal issues in the case relate to intangible asset items. The only intangible item on the registrant's balance sheet was "Patents and Patent Applications" which was carried in the amount of $2,014,941.03. The description of this item was as follows:

> "Patents and patent applications (representing the amounts of such assets as carried on the books of predecessor interests plus the excess of the stated value of common stock issued therefor over the net assets as shown by the books of such predecessor interests) (Note 2)."

Note 2 gave what we consider to be full information as to the basis of stating this item, pointed out that it did not purport to be the cost to the original owners, and showed the amounts at which intangibles were carried on the books of the predecessor interests.

The Commission has concluded that the item "Patents and Patent Applications" "improperly included material amounts without proper accounting evidence to support those amounts or to justify the certification of the figure stated for that account." Our position is that it was proper to carry this item at the amount stated because, among other things, it resulted from a series of transactions involving substantial elements of arm's-length bargaining, and that there was adequate disclosure in the balance sheet and footnotes concerning this item. The expert accounting witnesses

all fully supported our view that the evidence available warranted the accounting treatment we gave this item.

For an extensive discussion of these and the other issues, reference is made to the oral argument of the late Hon. Robert P. Patterson before the Commissioners on May 8, 1950, copies of which are available.

It is strikingly significant that it took the Commission almost two and one-half years after final argument to decide whether or not disciplinary action should be taken. Had professional misconduct existed, it would, by its very nature, have been clearly apparent.

The decisive issues in this case involved matters of judgment, not only as to the weight and meaning of the available accounting evidence, but also as to the proper accounting treatment to be based thereon. Even if the Commission is vested with final authority to make its own appraisal of this accounting evidence and override the judgment of the accountants who worked on the case and of the three independent experts, we submit that this authority should not be so exercised as to conclude that the accountants were involved in professional misconduct because their judgment and conclusions on these technical matters did not coincide with the judgment and conclusions of the Commission.

As soon as the text of the Accounting Series Release No. 73 is available, it is contemplated that a digest will appear in this column.

AN ADIRONDACK VIEW

The Three Bears. Well, all I know is what I learned in college and read in magazines.

Once upon a time a state game warden was getting his supper in his cabin near Lake Colden. He heard a large-sized noise outside—it sounded to him like a bear. He grabbed his flashlight and his gun and went out. There was a full grown bear with its head inside his pork barrel.

He let go with the gun. The bear was stimulated into quick and decisive action. Out went the bottom of the barrel, out came the bear's head and forelegs, and away went the bear, barrel and all.

Next spring on a balmy night the warden again heard a bear-noise outside his cabin. He grabbed his gun and his flashlight and went out. There was the same old bear and she was still walking around inside the pork barrel. And, also, there were two young cubs walking around, each inside of a keg!

And this, the New York Conservationist magazine article says, goes to prove that you can hear anything about bears.

We simply add, that the same goes for accounting and income taxes.

By Leonard Houghton, C.P.A.
of the "Adirondack Chapter."

Office and Staff Management

A Forum for the exchange of views and information on all aspects of the administration of an accounting practice.

Conducted by MAX BLOCK, C.P.A.

Personal Income Tax Declaration Procedures

The personal income tax declaration imposes on accountants a burdensome obligation unless dealt with in a very practical manner. Moreover, the average taxpayer could hardly appreciate, no less want to pay for, the attention that a declaration may require.

Theoretically, the accountant should obtain from the taxpayer an estimate of his next year's income. In many cases, because of the nature or uncertainties of the income, an estimate is difficult and time is consumed in such discussion. If a low estimate is filed, the client must be followed up, before the last instalment is due, to determine whether the estimate is too low and should be increased.

If this process must be followed for every taxpayer, it is conceivable that some accountants just could not cope with the volume of discussion and work involved. Many tax departments would be terribly bogged down.

The following practical course may be followed to reduce this burden to a tolerable minimum:

1. Declarations for every taxpayer should be prepared automatically when the income tax return is prepared.

2. Except in unusual cases, base each estimate on the prior year's income at the current year's tax rates, without consulting the client.

MAX BLOCK, C.P.A. (N.Y., Pa.) is a Director of the New York State Society of Certified Public Accountants and has been the Chairman of the Society's Committee on Administration of Accountants' Practice. He is a member of the firm of Anchin, Block & Anchin.

In relatively few cases, experience has shown, will taxpayers raise the issue that the estimate is substantially excessive. These cases, of course, must be analyzed. Taxpayers should be advised, when the question is raised, that it is in their interest to overestimate slightly to save the time and trouble of later again checking the year's income. Moreover, in the event of an error, an excessive underestimate may result in a penalty whereas an overestimate will avoid it. Finally, it should be pointed out that an overpayment is quickly recovered. Many taxpayers, it will be found, do not like to be presented with a large extra tax bill when the actual tax is calculated. They certainly will not object to this practice. In time, clients will be acquainted with the accountant's policy in handling declarations and it will be accepted, with rare exceptions.

3. Make a list of all underestimates, to provide a control for follow-up. These clients should be consulted before the last instalment is due to determine whether the estimate is too low.

4. The declaration may be mailed with the prior year's return. This will save postage and handling.

The Accountant's Files

Filing systems suffer from growing pains as accounting firms get older, their clients grow larger, and as they expand their clientele. These problems are essentially space problems. Old files can be transferred annually to outside warehouses or can be microfilmed. If the current file space is still inadequate then obviously it must be enlarged. If the space cannot be enlarged,

then the effective use of the space must be studied.

Inefficient filing systems can be wasteful of space, as well as of time in locating, removing, and refiling papers. For this reason a survey of the filing system is worth while before any important move is made to enlarge space and add new cabinets.

The following suggestions have been gathered from practitioners who have given careful study to their files.

Space wasters (other than the papers filed):

Certain items are large space wasters and should not be placed in the files unnecessarily. Amongst such items are clips, clasps, oversize folders, superfluous folders and name tabs, and anything else that need not get into the files. Where space is at a premium, which is true of most file rooms, care must be given to these details. Here the expenditure of time in removing unnecessary clips is justified by the cumulative saving of space.

The felony of space wasting is compounded by the continuous placement of clips and other paper clasps in the same spot. A staggering of clips, so that one does not rest directly on another, can save enough valuable space to be deserving of attention. Where papers are bound by large metallic clasps, a reversal of position will help. This requires merely that each second batch of papers be placed with the clasp at the other side of the file so that no two clasps touch each other.

Visual evidence of the amount of space consumed by clips and fasteners can be obtained by placing a dozen clips or other fasteners in a pile to see how high they stack up.

Name tabs consume a considerable amount of space. If more file divisions are used than are necessary, obviously more sets of tabs are required. If the divisions are all actually required, there is no alternative. But this may not necessarily be the case and the matter is worth study.

Every folder, open or closed, is a space consumer. How much space folders consume can be readily recognized by a glance at a box of new folders. Where folders are placed within folders there may be waste. Except where the convenience is really worth it, this practice should be avoided.

The envelope type of folder requires more space than the open style. This is so because the envelope has an extra thickness of flap and a projecting metal staple to keep the cord in place. Thus, where large numbers of envelope folders are used, thought should be given to their replacement in part, or in full, by open folders.

Expanding folders come in various thicknesses, in accordance with their expansion size. The greater the expandibility the greater the thickness. Obviously, there is both a cost saving as well as a space economy in using the smaller folder where possible. Even where two or three sizes must be kept on hand, instead of one, the inventory problem may well be offset by the saving in file space and cost.

Some folders are thicker than others. If there are hundreds of folders in the files the added thickness may represent all or a large part of a file drawer. Be sure that the extra thickness is really necessary. If justified by the amount of space saved, and if not required by other considerations, a thinner folder should be used despite its easier destructibility.

Files have been known to provide storage space for all sorts of articles such as the steno's work shoes and lunch, and other materials that could just as well be placed on shelves. Where file space is scarce, all extraneous matter must be excluded.

The utilization of air space above files for either shelves or additional file drawers should not be overlooked. This may be a simple way to enlarge the file room capacity.

(To be continued in next month's column.) *Note:* Readers are urged to send the Editor a memo concerning space-wasters they have found.

Notes on the New York State Unemployment Insurance Law

Conducted by Samuel S. Ress

Save Time in Receiving Forms LO 12—Request for Employment and Wage Data

At a conference between Mr. Milton O. Loysen, Executive Director of the Division of Placement and Unemployment Insurance of the State of New York, and a sub-committee of the Society's Committee on State Taxation, regarding the $10.00 per head penalty assessments made by the State against employers who had not answered the "Request for Employment and Wage Data" within 7 days of the date of mailing by the State to the employer, he suggested a method whereby some time could be saved by accountants who prepare and file these reports for their clients.

At the time an employee is laid off, the employer is required to give the employee a form IA 12.3 ("Record of Employment" slip). On this slip space is provided in which to indicate the employer's name and the address at which his payroll records are maintained. The employer may complete these slips with the name and address of the accountant as the place where the payroll records are maintained. A suggested form of such address is: XYZ Corp. (ER #89-11111), Employer, c/o John Doe, C.P.A., 22 Park Row, New York 7, N. Y. The State would then forward the "Request for Employment and Wage Data" to the accountant, instead of to the employer. Of course, those employers who filled in and mailed the reports themselves would continue to file them as heretofore.

It was pointed out, however, that so long as the law continues to read as it now does, whether the LO 12 is filed by the employer or the accountant, it must still be completed and signed and returned within 7 days of the date of mailing by the State.

Samuel S. Ress has been an Associate Member of our Society since 1936, and is also a member of the Bar. He has specialized in the payroll tax field since the inception of this type of legislation in 1936.

Dr. Ress is a member of the Society's Committees on Clothing Manufacturing Accounting, on Labor and Management, and on State Taxation.

Re: Proposed Amendments

The hardships imposed upon accountants because of the short period of time within which forms LO 12 must be filed with the State to avoid incurring a $10.00 penalty assessment for each delinquency was also taken up with Mr. Loysen and his principal aides. The Committee's legislative proposal to afford some relief in this connection was submitted and fully discussed. The State officials felt that the only way that they could secure better compliance with the law in this regard was to insist upon the imposition of the $10.00 penalty assessment. They pointed out that an original grace period during which no penalties for delinquencies were assessed had resulted in compliance in only 63 percent of the cases. However, after the institution of the $10.00 penalty assessment, commencing in December of 1951, compliance rose to 91 percent.

The Committee reiterated its request that relief should be afforded along the lines laid down in the proposed legislation as reported in the October, 1952, issue of the New York Certified Public Accountant. Mr. Loysen offered to cooperate further with the Society by appearing at a meeting with the members of the Society some time in the future, for the purpose of ironing out any difficulties that may have arisen since the enactment of the present provisions of the Unemployment Insurance Law.

Wage and Hour Law—Recent Decisions

Employees required to stand by for a possible call to duty during their lunch periods are entitled to overtime pay, to be considered as ordinary working time and not time spent in preliminary or post-work activities. The portal-to-portal pay act does not bar an action to recover the overtime pay under these circumstances. See the case of *Glenn Martin Nebraska Co.* vs. *Culkin,* USCA-8, decided June 24, 1952.

Where a substantial part of a rice mill's production was shipped to out-of-state customers, it was held that the services of a night watchman, which was necessary for the protection of the business, were closely related and directly essential to the production of goods for interstate commerce. The night watchman was therefore covered by the Wage and Hour Law. (*Broach* v. *McPherson,* Ark. Sup. Court, 248 SW-2nd 355.)

The Excess Profits Tax Exchange

Conducted by David Zack, C.P.A.

This department is a clearing house for questions, problems, comments and rulings regarding Excess Profits Taxes. We are especially interested in special and informal Bureau rulings on Excess Profits Taxes. All items of general interest will be published herein and full credit will be given all contributors unless they request otherwise. All inquiries and contributions should be addressed to:

Editor, The Excess Profits Tax Exchange
The New York Certified Public Accountant
677 Fifth Avenue
New York 22, N. Y.

Ceiling Rates on New Corporations

Robert M. Lande, C.P.A., has computed the following helpful table for the determination of the point at which the maximum excess profits tax for new corporations becomes effective:

Let P equal *Excess Profits Net Income*
& C equal *Excess Profits Tax Credit* (above $25,000 minimum)

Year	*Maximum*	*Formula*
1st	5% of P	P equals 1.2C
2nd	5% of P	P equals 1.2C
3rd	8% of P	P equals 1.3636...C
4th	11% of P	P equals 1.578947 C
5th	14% of P	P equals 1.875C

If the minimum credit of $25,000 applies, the following constants apply:

1st & 2nd year	$30,000.00
3rd "	34,090.91
4th "	39,473.68
5th "	46,875.00

David Zack, C.P.A. and member of the Bar, is a member of our Society and of its Committee on Federal Taxation. He is Chairman of the Committee on Municipal and Local Taxation.

Mr. Zack is a Lecturer on Taxation at The City College (N. Y.) School of Business and Civic Administration and at the New York University Institute on Federal Taxation.

Mr. Zack has written on tax matters for various publications. He is a partner in the firm of David Berdon & Co., Certified Public Accountants.

Unused Excess Profits Credit

Alexander Slater, C.P.A., contributes an interesting and practical point involving the unused excess profits credit adjustment.

"The 'unused excess profits credit adjustment' is an important element in the conversion of 'excess profits net income' into 'adjusted excess profits net income.' It is analogous to the net operating loss deduction in the computation of net income and it employs the same one-year carryback and five-year carryover principle. In the case of *partially taxable years* (years beginning before July 1, 1950), the Code and Regulations indicate that the credit is considered absorbed to the extent that

it is used, but only in the proportion which the number of days in the taxable year after June 30, 1950, bears to the number of days in the taxable year. The same principle would apply to taxable years ending after June 30, 1953. (I.R.C. Section 432 (b)).

"In case of a change of accounting period, a separate return is required for the short (less than 12 months) period. This short period for which a return must be filed is regarded as a taxable year. Under Code Section 432 (b) no proration is required of unused excess profits credit where an 'intervening' years is a period of less than twelve months. Consequently any carryover or carryback credit to a short taxable year will be absorbed to the extent of the annualized income of such short period. This may result in a loss of part of such carryover or carryback credit because the tax saving will be scaled down on the basis of the short period tax calculation.

"The inevitable conclusion is that a change in accounting period may place a taxpayer at a disadvantage. The Code should be amended to provide for the same method of apportioning the credit as in a partly taxable year. A similar inequity existed under the World War II excess profits tax law."

Consolidated Returns

The Bureau of Internal Revenue has ruled that affiliated corporations which filed Consolidated Federal income tax returns for taxable years ended prior to April 1, 1951, may, notwithstanding the filing of such returns, file separate Federal income tax returns for the first taxable year ending after March 31, 1951. (I.T. 4091, 1952-16-13882, p. 5.)

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We Extend

The Season's Greetings

AND

Our Best Wishes

FOR

A Very Happy New Year

To All Our Readers

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